Market View
Bond vigilantes hit the UK

In this week's Brief, we focus on the UK government bond markets, given the significant moves in gilts.

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At a glance

- Yields on 10-year gilts surpassed 4.8% for the first time in 17 years, and 30-year gilt yields exceeded 5.35% for the first time in 27 years
- Sparks memories of the 2022 mini-budget crisis, although represents part of a global trend in bond markets
- All eyes now turn to the BoE ahead of its February decision on further rate cuts

Gilts have been weak since the Labour government's budget in October, although broadly tracked US Treasury movements. But this week, we witnessed sharp moves, with yields on 10-year gilts—the annual interest cost of borrowing for ten years—surpassing 4.8% for the first time in 17 years, and 30-year gilt yields exceeding 5.35% for the first time in 27 years. This, combined with the falling pound, raised concerns over the fiscal outlook for the UK.

Labour entangled in its own rules

While there was no obvious catalyst for this surge in gilt yields, it appears investors are growing concerned about the UK's ability to meet its own devised fiscal rules. Chancellor Rachel Reeves introduced the Budget Responsibility Act, which aimed to provide clearer and stricter fiscal rules for the British government in response to the £22 billion black hole they claim was left by the previous Conservative government. The government's ability to meet these rules has become a source of concern. Following the autumn budget, Reeves was left with just £9.9 billion in headroom within the five-year forecast horizon to meet her revised fiscal rules.

Higher gilt yields mean the government will have to pay more interest on its outstanding debt. According to one calculation, assuming Reeves follows these rules, the 0.70% increase in gilt yields since the October budget implies the government's slim £9.9 billion margin has evaporated.[1] In other words, the government's £9.9 billion budget buffer has all but disappeared, leaving no room for additional borrowing or spending. This has effectively handcuffed the government, limiting them to either raising taxes or reducing government spending.

Thus far, markets have received vague comments about cutting expenditure rather than raising taxes, as the proposed national insurance hikes on businesses have already weighed on labour markets. According to the purchasing managers' index (PMI) survey compiled by S&P Global Market Intelligence in December, companies are cutting staff at the fastest rate since the global financial crisis, pointing to the government's budget and national insurance hikes.[2]

Fading popularity

Just six months after Labour's biggest landslide in a generation, the new government is already falling in popularity. The poll lead built by Prime Minister Keir Starmer has vanished, and now Labour faces a three-way battle against the Conservatives and Reform UK. The Green Party and Liberal Democrats have also made gains. While voters typically allow new governments some settling time—Tony Blair enjoyed a honeymoon period after his own landslide victory—Starmer has had no such luck, and the Labour Party's popularity will likely suffer further as mortgage costs are set to increase.

Another factor in the dramatic movements seen in gilts this week could be a result of Donald Trump's election win, as his victory may result in larger deficits and higher tariffs. In anticipation of these inflationary policies, the gilts market could be reacting, which the Labour government may be quick to point out. However, as previously noted, the Labour government already seems to be on the back foot as it appears to have no room to manoeuvre as it is within a whisker of breaking its own fiscal rules. It is unquestionably a precarious time domestically and globally, signifying that the gilt market shifts could be a combination of all these factors.

All eyes on the BoE

The Bank of England (BoE) has so far stayed on the sidelines, but all eyes will be on the bank at their next meeting scheduled for 6 February. The bank is widely expected to cut rates by 0.25%, bringing rates to 4.5%. The bigger question is whether this ongoing confidence crisis will alter their guidance of cutting rates by 0.25% per quarter. Furthermore, the BoE is the only central bank pursuing active quantitative tightening,[3] which is increasing the pressure on gilts. They may seek to make changes if concerns persist.

Conclusion

This week brought back memories of the 2022 'mini budget' crisis. However, responses so far have been more orderly, with government bond yields rising globally. The initial leeway afforded to the Labour government by investors has well and truly faded. Only time will tell if the government can execute its fiscal ambitions whilst maintaining market confidence. Market participants will be closely watching the government and BoE for developments over the coming days and weeks. Bond yields are at historically attractive levels, but confidence is needed to bring buyers back into the market.

[1] Lloyds

[2] S&P Global PMI survey: https://www.pmi.spglobal.com/Public/Home/PressRelease/001764ea766946389e4e4993b5b9e5ca

[3] Passive quantitative tightening is when the central banks' bonds mature, and they do not re-invest it into the bond markets. Active quantitative tightening is when central banks hold regular auctions to sell existing bond holdings, reducing their assets more quickly. There is debate about the impact active QT has on existing bond levels.

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