State of Play

Gilt-y pleasure

16 January 2025

What a difference a day makes. On Tuesday, a chorus of commentators, some less than impartial, declared the UK's economic situation a crisis, piling pressure on the Chancellor. By Wednesday morning, UK inflation had dropped to a steady 2.5%[1], and US inflation data later in the day proved similarly benign. The result? A sharp rally in the gilt market and a growing consensus that the Bank of England (BoE) will cut interest rates in a fortnight. Santander Asset Management digs deeper in this week's State of Play.

For months, the weakness of gilts (bonds issued by the UK Treasury to finance government spending) had been a thorn in the government's side. While the BoE sets short-term interest rates, longer-term borrowing costs are determined by the performance of the bond markets. These, in turn, influence mortgages, annuities, and other long-term lending levels.

Recent months have seen bond markets, particularly in the UK, in decline. Falling prices have driven yields higher, with borrowing costs reaching levels not seen since 2008. Earlier in the week, the yield on a 10-year gilt began to approach 5%[2], a stark contrast to the near-zero rates of 2020. This is no small matter for a government already navigating tight fiscal constraints. Rising borrowing costs add pressure to servicing the national debt, leaving little room for manoeuvre without tax increases or spending cuts, both of which carry their own economic risks.

But is the UK truly on the brink of economic crisis? The economic data has room for improvement, but we are far from a catastrophe. Inflation, at 2.5%[1], has fallen dramatically from over 10% in 2023.[1] While government debt exceeds 100% of GDP[3], it remains below the pandemic peak and is lower than the average of the largest developed nations. The budget deficit, at 4.7%, is less severe than the 15-year average and notably better than that of the United States.[4]

So why have UK bond markets been under such pressure? Part of the answer lies overseas. Donald Trump's return to the White House, coupled with his administration's inflationary rhetoric, including charging import tariffs on all its trading partners, has unsettled global markets. Yet markets often overreact to political theatre, and it's not our view that the new US administration will be in the business of scoring economic own goals.

Closer to home, October's UK budget also played a role. Ironically, criticism centred on its tax hikes and spending cuts - measures designed to shore up fiscal stability. The Chancellor has steadfastly adhered to her fiscal rules, a stance that, over time, could restore investor confidence. Compounding the situation, the BoE has been offloading its stockpile of gilts acquired during the financial crisis. This so-called 'quantitative tightening' is likely to ease later this year.

For borrowers, whether homeowners, businesses, or the government itself - high interest rates are undeniably painful. But there is another side to the coin: savers, after years of disappointing returns, are finally reaping the benefits of higher deposit rates.

The post-financial crisis era saw savers suffer as rates hit record lows. Headlines lamented the plight of pensioners and the erosion of savings. Today, the picture is starkly different. UK households now hold slightly more savings than debt, according to the Office for National Statistics. For older homeowners with reduced mortgages and significant retirement savings, the higher returns on offer are a welcome change.

The current landscape presents various options for portfolio managers. Inflation-linked gilts are now providing returns that include Retail Price Inflation, which has averaged 3.5% this century, along with an additional 2% per annum for 30 years—marking a level not seen in three decades. We can access one-year gilts that offer yields of around 4.6% per annum, while five-year issues yield approximately 4.5%.[5]

Portfolio managers like Santander Asset Management, have an opportunity to access higher yields for our funds from both government and corporate bonds, improving overall returns (though not guaranteed), especially for more conservative (lower risk) mandates.

Lower gilt prices can mean higher returns for new buyers. And if the economic outlook improves, a rally in government debt could be on the horizon. Portfolio managers who seize the moment in their funds may be thankful for the gilt-edged opportunity served up by today's political noise.

Note: data as at 16 January 2025

[1] Bank of England, 15 January 2025
[2] Morningstar, 13 January 2025
[3] OBR, 20 September 2024
[4] House of Commons Library, 4 September 2024
[5] Bloomber, 15 January 2025

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