

## Is UK political drama really a disaster for gilts? It's complicated...

UK borrowing costs have tumbled through February, but will politics put an abrupt stop to that? Tuesday's Spring Forecast is likely to emphasise that the short-term fiscal backdrop looks brighter, even if longer-term challenges haven't gone away. We think neither fact is likely to change drastically this year, regardless of politics



UK Chancellor Rachel Reeves and Prime Minister Keir Starmer. Tuesday's statement might highlight an improved short-term fiscal backdrop, but deep-seated challenges are likely to persist

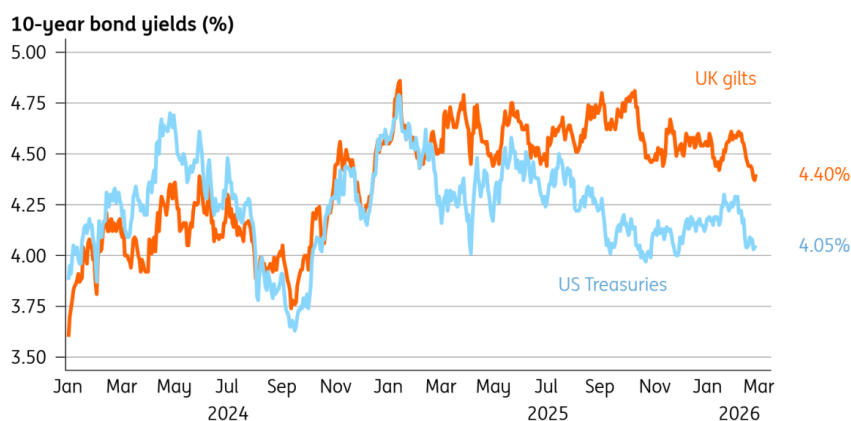
### Investors have fallen back in love with UK gilts

UK government bonds (gilts) are back in vogue. 10-year yields are down more than 20 basis points on the mid-February highs, helped by lower US rates. London-based bond investors we spoke to earlier this month were overwhelmingly overweight (ie holding more) gilts.

Diminishing inflation risks are increasingly cited as a source of optimism. The two-year swap rate – a gauge of Bank of England policy expectations – is at new lows. More recurrent US equity market jitters make gilts more attractive too, as a shelter from AI-related volatility. The spread between gilt and swap rates is narrowing, suggesting healthy demand.

And for now, all that's helping to keep political concerns at bay. Risk premium in gilts has evaporated. Yields are much closer to our long-term fair value estimates.

## UK gilt yields have fallen with US Treasuries



Source: Macrobond, ING

## The "Spring Forecast" looks like a non-event

But can that last? There's no shortage of political flashpoints over coming weeks – from the fallout of this week's by-election in Gorton and Denton, to challenging local elections on 7 May. Nationally, Labour are polling 18% according to YouGov, down from around 35% at the 2024 general election. Keir Starmer's position as Labour Party leader – and therefore as Prime Minister – still appears vulnerable.

That all threatens to overshadow next Tuesday's "Spring Forecast". UK Chancellor Rachel Reeves will be keen to avoid a re-run of last year's statement, where financially modest but politically seismic welfare changes sparked a huge political backlash and ultimately U-turns.

Fortunately for the Treasury, the Office for Budget Responsibility's forecasts are likely to be little changed – certainly nothing that's likely to drastically alter the comfortable levels of "headroom" available under the fiscal rules. Next week's announcement is likely to be low-key.

So what happens if leadership noise resurfaces? A few short-lived gilt sell-offs last year offer a clue to the financial market reaction. A new prime minister would likely mean a new chancellor (finance minister). A new chancellor might mean new fiscal rules. And new fiscal rules would presumably herald more borrowing and gilt issuance, potentially complicating the Bank of England's rate-cutting cycle. UK yields likely go higher again if those risks resurface.

That may well be the short-term playbook, but is it the right reaction? The reality looks more nuanced.

For one thing, Labour Party rules don't make it easy to change leader. 20% of Labour MPs need to back a rival candidate to trigger a contest. That's 81 lawmakers. Even if that number push for a change in leader, can they all agree on a single nominee?

In the event a Labour leadership challenge is triggered, though, we think there are four questions we'd need to answer:

## Would there actually be a change in the fiscal rules?

We aren't so sure. The 2022 mini budget crisis, which temporarily lifted mortgage rates, is still etched firmly in the national political memory. Leadership contenders, wary of doing anything that might spark a repeat sell-off in bond markets, will be under enormous pressure, we suspect, to commit to the rules as they are currently written. If they do, that would be received positively by bond markets.

### 2 Would a new leader dramatically alter the near-term fiscal story?

The backdrop is looking more positive. We think it would take a lot to stop the budget deficit falling further this year.

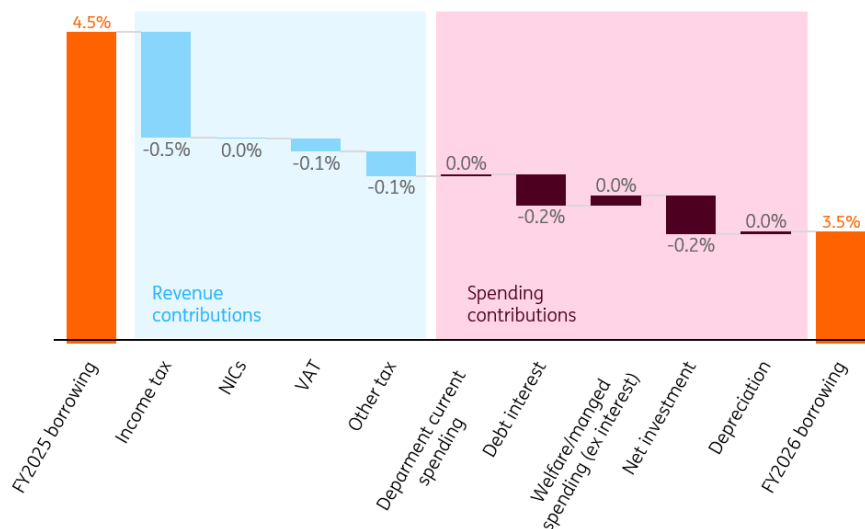
The FY2025 deficit looks like it will come in at 4.3%, below the Office for Budget Responsibility's (OBR) 4.5% forecast and the 5.1% recorded in the previous year. It's on track to fall to 3.5% this year. Gilt sales, though still elevated, are set to be materially lower – circa £250bn vs £300bn in the current fiscal year.

Much of the forecasted deficit decline – 0.5ppt – is down to rising income tax receipts, a consequence of the ongoing freeze in payment thresholds. Inflation means an increasing number of people get dragged into higher tax brackets. No chancellor is likely to row back on that policy. Another 0.2ppt of the decline is owing to a slight fall in net investment as a share of GDP – again, something that's not likely to change overnight given the lags involved with capital spending.

To offset those two factors and prevent the deficit falling below 4.3% would require a £23bn increase in (for example) day-to-day departmental spending budgets. That would be a 6% real-terms increase – significantly higher than the 1.8% that's budgeted, or the 3-3.5% increases we've seen over the past couple of years. And that sort of spending increase wouldn't be permissible under the fiscal rules, unless it were temporary.

In short, borrowing is coming down in the near-term and the bar to stopping that is high.

## Contributions to the fall in the UK deficit between FY2025 and FY26 (OBR forecasts)



Source: Office for Budget Responsibility, ING

### 3 Would an increase in borrowing/spending move the needle for the Bank of England?

In theory – yes. Higher spending means higher growth and ultimately inflation over the two-year horizon the Bank bases its decisions on. But in practice? Our view is that the BoE will cut rates in March and June. The next budget isn't until October/November.

We wouldn't rule out further cuts beyond June. And markets may be tempted to start pricing that, should the inflation outlook continue to improve. A stimulative budget might stop or at least delay more easing. But if we're right that the easing cycle is done and dusted by the summer, how likely is it that the Bank comes in and hikes rates once or twice in response to looser fiscal policy? The answer is "not very".

### 4 What would a leadership contest mean for the UK's longer-term fiscal challenges?

This is where things look more problematic – regardless of who is in charge.

Beyond 2026, the Treasury's spending plans become unrealistically austere. Real-terms departmental day-to-day spending is budgeted to remain flat in 2029 – and falling in per-capita terms. And 2029, remember, is an election year.

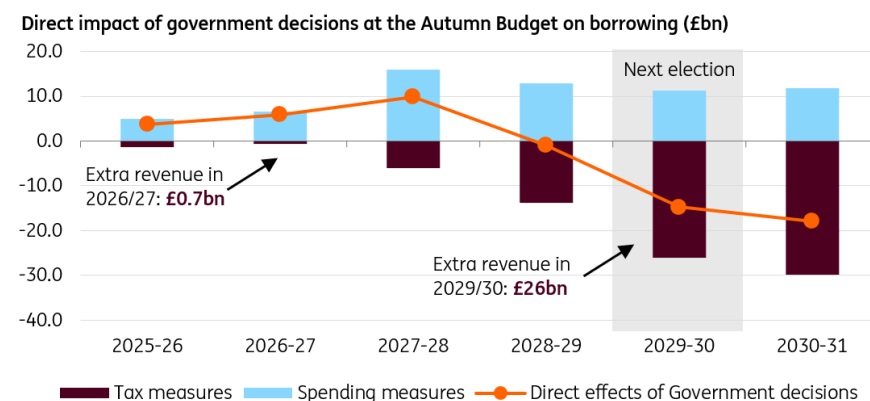
Politics isn't the only reason those spending plans are likely to eventually get topped up. Reports suggest the government is planning to boost defence spending so that it reaches 3% of GDP in the current parliament. The latest budget plans have it rising to 2.5% by 2027 and staying there. Getting to 3% by 2029 comes at an annual cost of £17bn.

A lot of that would likely be capital spending – military equipment – which isn't counted against the main fiscal rule, requiring revenue to balance out day-to-day spending by FY2029. But it would

count against the second rule, to stabilise Public Sector Net Financial Liabilities (a broader measure of public debt) as a share of GDP.

Headroom against this target is £24bn. Given debt is a stock measure, any extra spending will accumulate over time. The earlier the defence spending commitment is reached, the more likely it is that this target gets broken.

## November's tax hike announcements backloaded to 2029



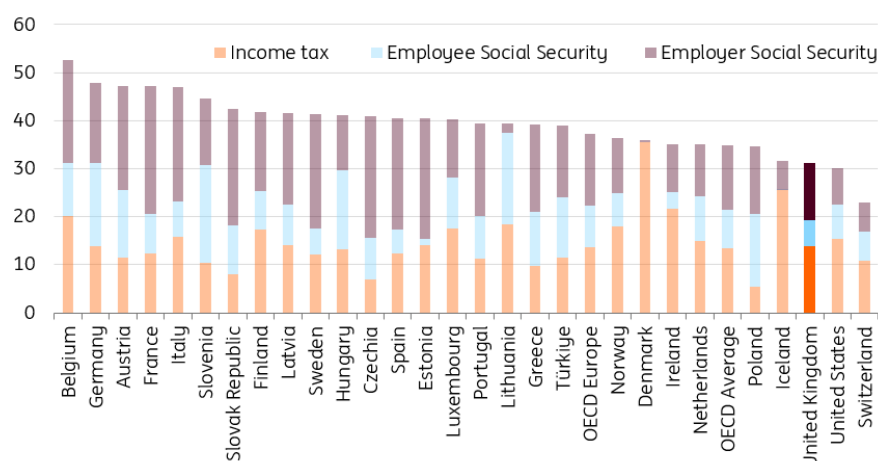
That leaves the government with a painful choice. Does it hike taxes, which are already going up in 2029? Most of the planned revenue-raisers in last year's budget don't kick in until then.

Remember that tax on the average UK worker across income tax and employee/employer National Insurance (social security) is among the lowest in Europe as a proportion of total labour costs. In the absence of higher economic growth, the uncomfortable reality is that if the government wants (or needs) to spend more, it will be hard to do so without raising at least one of the major tax rates.

Yet that's going to get harder, politically, as we approach the next election. That might shift focus back to the alternative, which is to boost borrowing via a change in fiscal rules after all.

So, while the near-term fiscal story looks better – and should remain the dominant theme for markets – it doesn't take away from the fact that difficult and currently unanswered questions loom later this decade.

## Tax rates as a share of average labour costs (%)



Source: OECD, ING analysis

UK data has been recalculated to reflect April 2025 employer NI increase. OECD Europe calculated by ING. Labour costs defined as average salary plus employer social security contribution.

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