

Rates Spark: Stakes are high for the UK budget

The UK government's budget announcement will need to show fiscal discipline to satisfy gilt investors, and while our baseline sees enough credibility to nudge the risk premium in gilt yields lower, we are well aware of significant upside risks too. Foreign gilt investors are relatively important and could even gain in importance in the future



We see enough credibility for the UK's Autumn Budget to nudge the risk premium in gilt yields lower

UK Budget: Our baseline sees a lower gilt risk premium, but upside risk is significant

The UK's Autumn Budget, due today, is set to contain a raft of hikes to minor taxes. The details of the chosen measures have become clearer over recent days, though the key question for investors is how much of this kicks in immediately (or in 2026). The more the tax hikes and spending cuts are pushed back to later this decade, the less scope the Bank of England will have to cut rates, the greater the FY2026 supply issuance, and the more sceptical investors will become about the country's fiscal discipline.

Gilt markets have been quite volatile in the run-up to the budget and more price swings are possible as the details emerge. Our baseline is one where the Chancellor does deliver the required

budget adjustment to meet the fiscal rules and engineer a material fall in the FY2026 deficit, but a sharp rise in yields is possible if either the fiscal consolidation isn't perceived as sufficient, or if political pressure builds on Chancellor Reeves in the aftermath.

Gilts rely on foreign investors' trust to keep yields at bay

Fiscal credibility is especially important given the gilt market's strong reliance on foreign investors. Around 30% of gilts are held overseas, which is more than, for example, the eurozone, where foreign investors hold c.22% of outstanding government debt. Over the past months, gilt swap spreads have often tracked French and Italian bond dynamics more closely than the safer German Bund, underscoring market awareness of the underlying fiscal risks.

The UK's fiscal outlook is still a lot better than that of the US, but gilts do not enjoy the privilege of being the number one global reserve currency. Meanwhile, higher yields on Japanese government bonds are competing against gilts, potentially providing more upward pressure on sterling rates. When we look at the overseas holdings of eurozone government debt, we see that foreign investors are particularly interested in countries with strong government finances. This also suggests the UK's fiscal credibility is key to keeping global investors interested.

Foreign investors could become even more important in the future because domestic demand is likely to come down further. As of late 2024, around 30% of gilts were held by pension funds, but the transition from defined benefits to defined contribution schemes may bring the share down to just 10% over the long term. Meanwhile, the Bank of England is unwinding its bond portfolio, adding to the supply pressures. To contain the upward pressure on gilt yields, the UK may therefore have to rely on external demand.

Wednesday's events and market view

The UK budget announcement is the main event of the day. There will be no notable eurozone data releases, leaving the focus here on some of the scheduled speakers, such as Chief Economist Lane, as well as the ECB's financial stability report.

Main data releases for the day will come out of the US as markets are firming up their expectations of a December rate cut again, after Fed members Daly and Waller backed a December cut over the past days. Today's durable goods orders and initial jobless claims might be less market-moving than the evening's Fed Beige Book, which collects anecdotal evidence from the individual districts. Given the still-limited visibility on data following the shutdown, this could be even more relevant than usual to decide the outcome.

Admittedly, for the broader market, the exact timing of cuts might be less relevant than the actual amount delivered by the end of the easing cycle. But for now, the market is back to pricing a 90% probability of a Fed cut next month. This has added to the bullish tone in rates, which has taken the 10y UST back to 4%.

In terms of issuance today, Germany will sell €3bn in 10y Bunds and the US Treasury US\$44bn in new 7y notes.

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