

Why politics is the biggest risk to UK gilts in November's budget

Gilt yields jumped after reports the UK government was scrapping plans to raise income tax, casting fresh doubt over how a £30bn gap will be plugged. We expect about half to come from upfront tax hikes, so yields may not climb much further. If we're wrong, blame the politics



UK Chancellor, Rachel Reeves

Gilt yields have risen on BoE repricing and increase in risk premium

With a little more than a week to go until the UK's Autumn Budget on 26 November, financial markets are looking twitchy. Government bond (gilt) yields are up 15 basis points from their low last week on [reports](#) that the Treasury has abandoned plans to lift income tax, supposedly on the back of better economic forecasts.

So are the markets losing faith in the budget and the government's ability to maintain fiscal discipline? Not quite.

For context, it's worth remembering that gilt yields are still down some 20 basis points from their

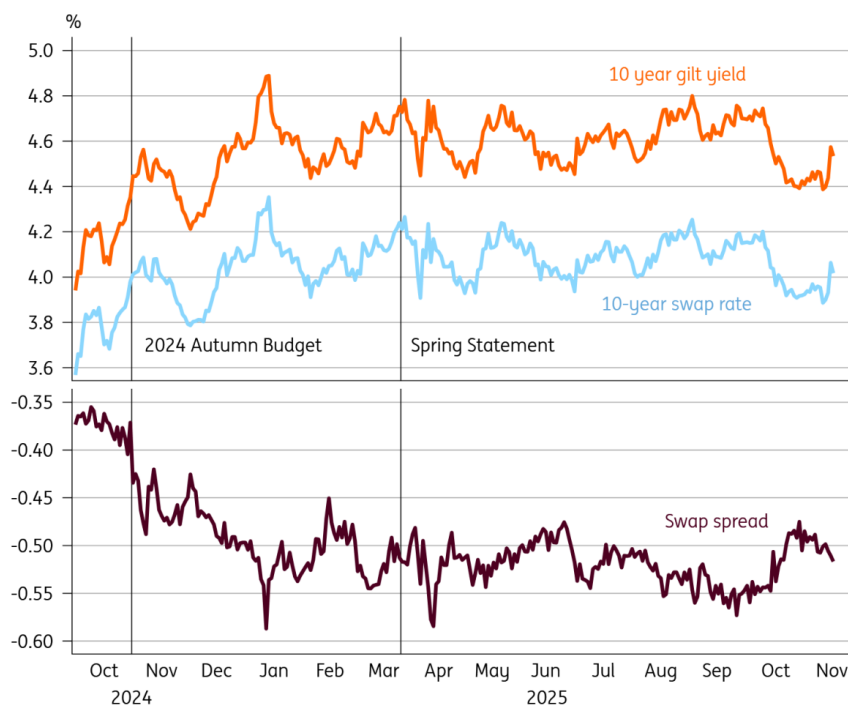
levels in mid-October. And just as the big fall in yields had been driven overwhelmingly by growing anticipation of Bank of England rate cuts, the latest spike is partly because those cuts have begun to be priced out again.

Put simply, if the government is signalling the size of the fiscal hole is smaller than previously thought, then so too will be the need for fiscal tightening. And less fiscal tightening – tax hikes – means higher growth next year and less need to cut interest rates.

But the saga has also left markets factoring in a little extra risk premium than it was before. Our Rates strategists estimate that, based on the historical relationship between FX-hedged UK bonds and global bond yields, the risk premium in 10-year gilts has risen to 13bp from 6bp a few days ago, though still below the 25bp seen earlier in October.

Investors are acutely aware that there’s still a big fiscal hole to be filled. Events of recent days have left them more sceptical about how that’s likely to be done.

Gilt yields spiked 15bp after income tax reports



Source: Macrobond, ING

The Treasury faces a £30bn hole to fill

After all, the scale of the task remains sizeable, even if the economic predictions from the Office for Budget Responsibility – the government’s independent forecaster – aren’t allegedly looking so bad.

The [FT reported last week](#) that the government is facing a fiscal hole of £20bn relative to its position back in March. Our best guess is that this is driven by a 0.3pp/year productivity growth forecast downgrade (-£21bn), offset partially by a boost to future tax revenues from higher near-term wage growth/inflation (£6bn). Fortunately, recent falls in gilt yields mean debt interest projections should barely change. Add back in previous U-turns on winter fuel payments and

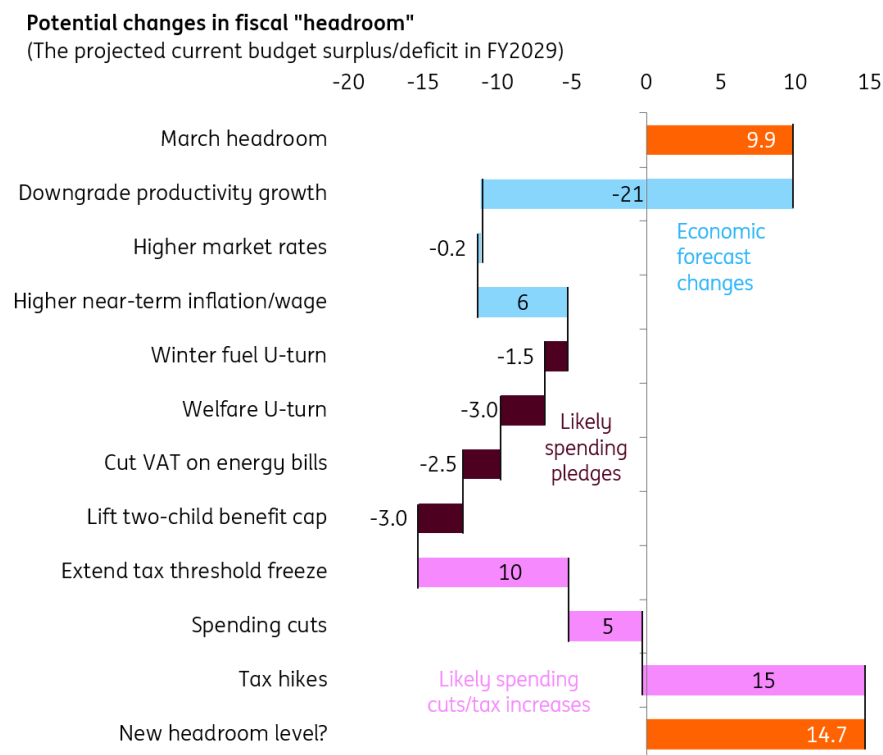
welfare spending (-£4.5bn), and you arrive at that £20bn reported figure.

On top of that, we also know that the government is [seriously considering](#) lifting the controversial two-child benefit cap, as well as a VAT cut on energy bills. Together, they amount to an estimated £5.5bn/year, according to the Institute for Fiscal Studies.

Remember, too, that the government is keen to leave itself with more headroom than it did in March, in a bid to avoid exactly the situation it finds itself in today, which is to increase taxes simply because the economic backdrop has soured.

If the Treasury left itself with £15bn of headroom, rather than the £10bn it had in March, then we suspect there's a £30bn hole to fill. How that is filled will determine whether gilt yields have further to rise.

How the government may lose "headroom" - and how it could get it back



Source: OBR, IFS, FT, ING analysis

Based on ING expectations of the Autumn Budget and possible OBR forecast revisions, together with policy costings from IFS/others.

Expect £15bn of frontloaded tax hikes

We recently [outlined](#) six ways that the budget could upset markets, but it boils down to how frontloaded tax hikes are likely to be – and therefore, whether the 2026 deficit and resulting gilt issuance fall, as previously forecast.

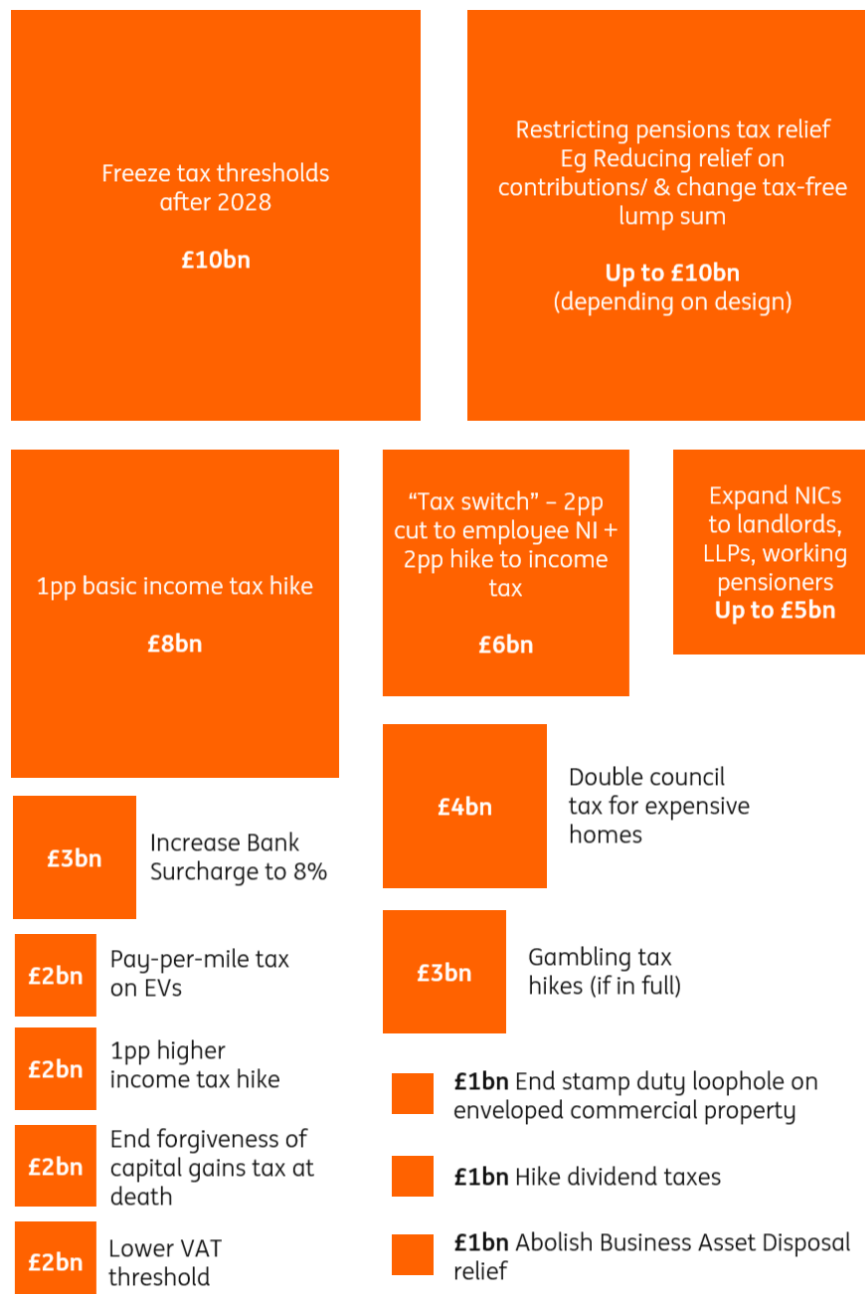
Some of the gap is likely to be met by extending the freeze on tax thresholds later this decade, raising £10bn/year. That obviously makes no difference to the finances next year, but has long been the base case of most investors.

The Treasury is also hoping to achieve some spending cuts, though these are likely to be minimal given political pressure. We struggle to see these amounting to more than £5bn/year, coming from a combination of cutting welfare spending on cars and trimming departmental budgets later this decade.

The latter would be met with scepticism among investors, given those budgets will likely be topped up again nearer the time. Assuming the numbers are small, though, we suspect it will be overlooked. But the more the budget leans on this kind of future austerity, the more likely gilt yields are to rise.

If we're right, then tax hikes worth £15bn/year by 2029 will also be necessary. Without a rise in the major taxes, this looks likely to be filled by a combination of raising council tax on expensive homes (£4bn), extending national insurance to landlords (£2bn), pay-per-mile EV taxes (£2bn), and other changes to minor taxes.

The tax raising options



Source: IFS, Resolution Foundation, various news reports

Admittedly, a budget filled with big hikes in lots of minor taxes, as opposed to one small hike in income tax, carries much more uncertainty about how much money it will all raise in practice. A shortfall in revenues from minor taxes accounts for much of the overshoot in borrowing this year.

Still, this setup, where roughly half the fiscal hole is filled by upfront tax hikes, feels like it is well priced now. Unless tax hikes are much less frontloaded in 2026, we doubt gilt yields need to rise materially on the back of this budget. Ultimately, next year's deficit is set to fall from circa 4.3% this fiscal year to close to 3% next year, largely because of the freeze in tax brackets. It's an underappreciated point, and one that's almost certainly not going to change as a result of this budget.

We also think the bar is fairly high for the budget to block a December rate cut from the Bank of

England. That decision [almost exclusively hinges](#) on the vote of Governor Andrew Bailey, and he's hinted that unless we get any unpleasant surprises in the next couple of inflation releases, then he is minded to cut rates further. Markets are putting an 80% probability on a December cut.

The big risk for markets: politics

If gilt yields are to spike in the aftermath of the budget, then it's more likely to be because of the politics. The ruling Labour Party's poll ratings have fallen through 2025, and Prime Minister Keir Starmer is coming under mounting pressure within his party, not helped by recent communications missteps.

Were a leadership challenge to become a more imminent possibility, which at the moment, it's not, then markets may quickly assume that a new PM would mean a new chancellor. And a new chancellor, perhaps more left-leaning than the incumbent Rachel Reeves, would be seen as more likely to change the fiscal rules and increase borrowing.

That would come at a time when gilt issuance is still elevated – even if it's set to fall next year under current budget plans. And a moment in July where it briefly appeared that Reeves' job security was under question saw a material, if short-lived, spike in longer-dated yields. That revealed just how sensitive investors are to Labour party politics, a theme that will persist as we head into potentially challenging local elections next May.

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