The UK's bond yield spike is reaching its limits

British 10-year government bond yields have risen almost as far as in the US since the start of October, following a surprisingly bold budget. But we think that the rise in borrowing costs, particularly in shorter-dated bond yields, could struggle to go much further

Downing Street, London

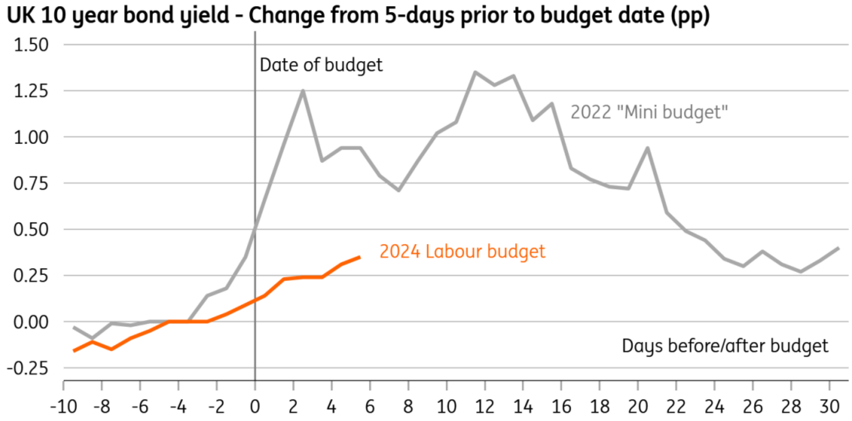
The UK's budget has sent bond yields higher

The dust has settled on the first UK budget under the Labour government, and the financial market verdict is clear. Borrowing is going to be higher, and the perceived impact on growth and inflation means that the Bank of England will be forced to cut rates more slowly.

That might sound surprising, given the tax hikes in this budget will generate £40bn/year in additional revenue after five years. But only £25bn of that will materialise in the next fiscal year, and that's set against roughly £60bn extra in additional spending over the same period.

Bond yields had settled some 25bp higher than before the budget and ahead of the US election. That's a big reaction, though considerably less so than the aftermath of the so-called "mini budget" in September 2022. Interestingly, financial markets have been much more reticent to price additional rate cuts in the UK following Donald Trump's victory than they have in the eurozone.

UK bond yields have risen post-budget, though not nearly as much as after the 2022 "mini budget"



Source: Macrobond, ING calculations

Why UK yields could struggle to rise further

We think this upward repricing in UK rate expectations is looking stretched. After this month, there are fewer than three rate cuts priced for the next two years. By any reasonable estimation, that would leave Bank Rate well above neutral across the medium term, at a time when markets think the European Central Bank will take rates below 2%.

There are three reasons to treat the financial market reaction to the budget with caution. Firstly, the last budget in March baked in big real-terms cuts across government departments. Those were never going to be realised, so spending plans were always going to get revised higher – even if the scale was still a bit of a surprise. The budget deficit is expected to be almost a percentage point smaller as a share of GDP in the next fiscal year than the current one.

Secondly, we're sceptical that government investment will rise as quickly as the projections suggest. Capital spending is expected to be £18bn higher next year, which could be difficult to mobilise in such a short period of time.

Thirdly, some investors are assuming that the additional tax employers must now pay on worker salaries will just get passed on in the form of higher prices. But firms' ability to pass on higher costs has waned over the past year or so. And the tax rise could amplify the existing weakness that is emerging in the jobs market. Excluding government-related hiring, employment has fallen by 0.8% since the turn of the year, according to payroll data.

The bottom line is that the spread between US and UK yields is likely to gradually fall over the coming months, particularly for shorter-dated bonds. We think the Bank of England's outlook looks more similar to the Fed or ECB than markets currently assume.

Admittedly, we're sympathetic to the view that the budget has reduced the chances of a December rate cut. We've removed that from our latest forecasts.

But the inflation story is looking brighter. Services inflation data has been undershooting Bank of England forecasts and surveys suggest further declines are coming in 2025. That should enable the BoE to move faster on rate cuts from the first quarter of next year.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

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