UK bond yields spike as budget boosts borrowing

Financial markets have been on a wild ride since the announcement of the UK's latest budget. Big tax rises are coming, but not as quickly as big spending increases. And the prospect of higher growth has led investors to curtail expectations for Bank of England rate cuts

Rachel Reeves, Chancellor of the Exchequer

Markets initially liked the tax hikes, but quick spotted the higher borrowing projections

UK Chancellor Rachel Reeves has delivered the new Labour government's budget, and if she was hoping for a smooth reception in financial markets, so far it has been anything but.

UK bond yields did initially dip as the chancellor was speaking, and markets liked Reeves' confirmation that tax rises would raise £40bn (1.5% GDP) per year. That's a big number by any comparison and is much more than Labour promised to raise during the general election. Investors also warmed to Reeves' commitment to balancing the current budget (day-to-day spending vs taxes), initially within five years, and latterly over three.

But no sooner had the chancellor ended her speech did the tide quickly begin to turn. 10-year government bond (gilt) yields are up four basis points on the day, at the time of writing, and almost 15bp from the intraday low.

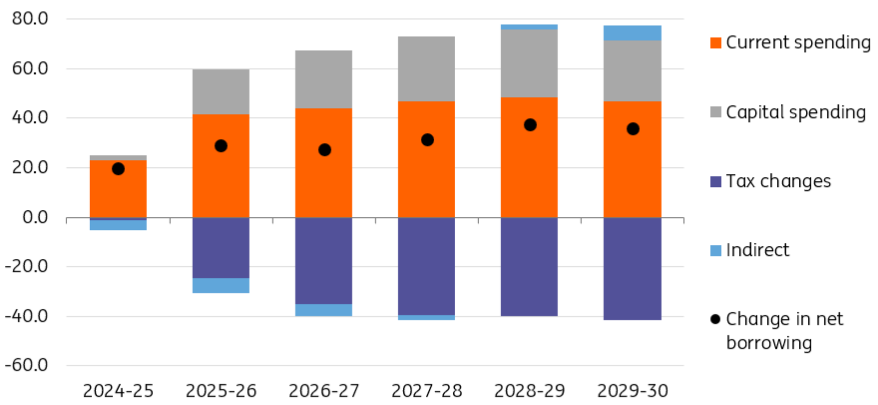
Now that the full details are available, what immediately stands out is just how much borrowing is projected to rise over the next few years. The Independent Office for Budget Responsibility reckons that borrowing will, on average, be £36 billion (1.3% of GDP) higher each year over the next five fiscal years. That's a big number, and the updated Debt Management Office gilt remit confirms that will result in a sizeable increase in bond issuance.

That might sound surprising, given the scale of the tax rises. But crucially, not all of the promised £40bn/year extra tax revenue will arrive straight away. In fact, the OBR estimates that only £25bn will show up in the next fiscal year, most of which comes from the hike in employers' national insurance (social security). The myriad of other revenue-raisers will take more time to show up in full.

Tax rises may be coming through gradually, but the corresponding rise in spending does not. OBR numbers confirm that day-to-day spending will rise by £41bn next year, compared to previous plans. In real terms, that's an 8% rise in spending across two fiscal years. Capital spending is £18bn higher next year, too.

We've argued for some time that the government had little choice but to raise real-terms spending. But what has been delivered is undoubtedly higher than many had expected just a few weeks ago.

Policy changes have lifted government borrowing projections



Source: Office for Budget Responsibility

We're sceptical the budget will dramatically rewrite Bank of England's rate cut path

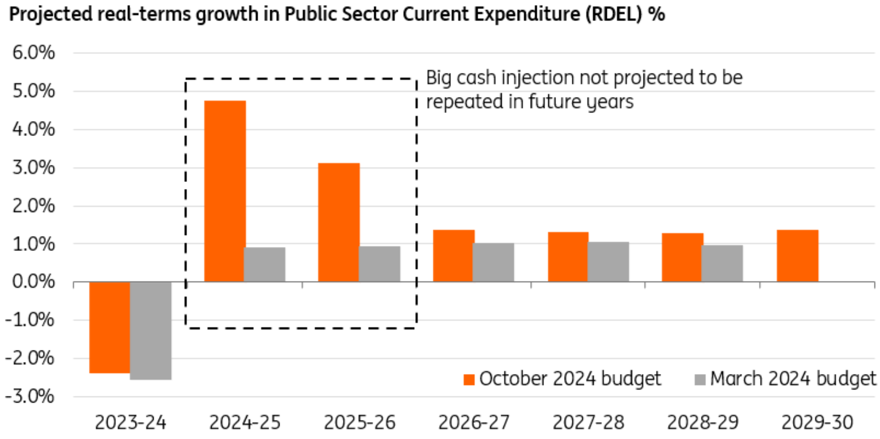
With tax rises not initially expected to match higher spending, the OBR reckons that this nets out as a half-a-percentage point boost to GDP next year.

It's this stimulus effect, much more so than any concerns about extra issuance, that investors seem to have really latched onto. Financial markets no longer expect the Bank of England to cut rates as aggressively, and now expect interest rates to land a little closer to 4% than had been priced just a few hours ago.

Are markets right to anticipate slower rate cuts? Not necessarily. Remember the Bank of England is almost exclusively focused on services inflation, which has begun to undershoot policymakers' expectations. We think that's set to continue, and Governor Andrew Bailey has hinted that this could accelerate the pace of cuts.

Admittedly, the extra spending announced in this budget does make us a little less confident in our forecast for a December rate cut, which would follow the 25bp move widely expected next week. But the BoE's response to fiscal loosening, both earlier in 2024 and this time last year, was fairly muted. In other words, we still think the Bank of England will deliver more aggressive rate cuts than markets now expect. We maintain the view that gilt yields are too high internationally and that falling inflation and a more dovish BoE should help lower yields again. UK 10-year yields have risen above their US equivalents, but that might not last long.

The boost to spending plans is relatively short-lived



Source: Office for Budget Responsibility

FX: Intra-day volatility, but no knock-out blow

Budget day has generated much intra-day sterling volatility – albeit in relatively narrow ranges. Sterling is being priced by the trade-off between the fiscal/monetary mix versus the fiscal risk premium of extra gilt supply. It is probably fair to say that those two forces are counter-balancing each other today. Today's read is that the budget delivers slightly looser fiscal and tighter monetary policy (sterling positive), but at the same time, gilt supply is demanding (sterling negative).

As above, however, if the Bank of England is to look through the government's spending plans, focus on softer services inflation and deliver faster easing than the market currently prices, then sterling should start to underperform. Next Thursday's MPC meeting could be the opportunity for another re-assessment of the BoE easing cycle, as could upcoming UK inflation numbers. And while we are slightly bearish on sterling medium term, the uncertainty surrounding US elections and the shape of the eurozone economy make it hard to offer a conviction call on sterling right now.

Why further tax rises could still be delivered

One final question: will the government be forced to raise taxes again over the next couple of years? Certain details buried away in the OBR report suggest it might.

While the cash injection for public services is substantial over the next year or so, departmental spending is set to rise by just 1.3-1.4% per year in real terms from 2026 onwards. That marks only a slightly increase on the previous Conservative government's plans. Given that much of this will likely be absorbed by health, it implies that many other government departments will see budgets either frozen or decline in real terms later in parliament. Is that realistic, given the deteriorating quality of many public services?

In practice, we suspect the Treasury will have little choice but to raise spending further than these projections imply. If we're right, that means further difficult tax decisions are inevitable.

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