UK: Our answers to the big questions of the past two weeks

Will the Treasury be forced to cut spending in March, and are taxes going up again? Would that be enough to ease fears in bond markets? And how quickly will the Bank of England be able to cut interest rates this year? Here are our answers

Chancellor Rachel Reeves, the UK's Finance Minister, in Beijing earlier this month

Some much-needed calm has tentatively returned to the UK bond market after a tumultuous start to the year. 10-year gilt yields have slipped back below 4.7%, having come within touching distance of 4.9% earlier this month. That volatility says as much about the US as it does the UK, but uncertainty surrounding Britain's inflation, interest rate and fiscal challenges remain ever-present. Here are our answers to the biggest questions of the past two weeks...

Has the Treasury run out of 'headroom'?

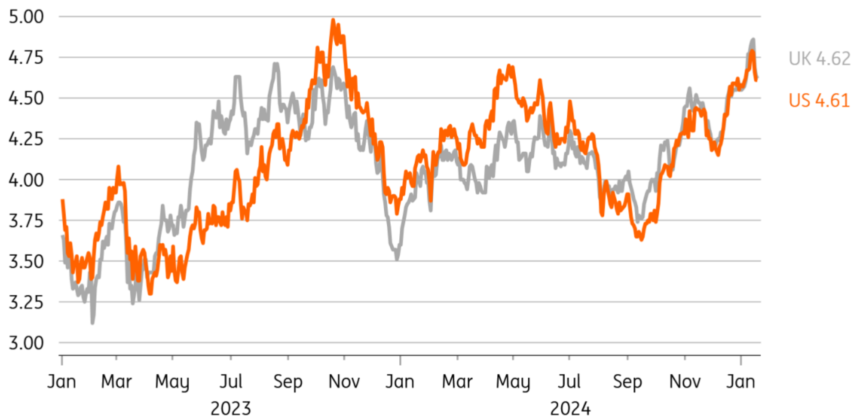
Rising global yields over recent weeks have inevitably shone the spotlight back on the UK government's decision to dramatically ramp up spending in its Autumn Budget. It saw big tax rises but even bigger increases in day-to-day spending (worth 1.5% of GDP), as well as extra cash for infrastructure.

But it was a budget that left little margin for error – or “fiscal headroom”. The UK’s fiscal rules require the current budget (day-to-day spending vs. revenues) to balance in five years’ time. The Office for Budget Responsibility - the independent body that assesses the government’s fiscal plans – judged at the time that this would be met by just £9.9bn.

Recent market moves will have eroded some, if not all, of that margin. The OBR’s ready-reckoner hints that a 60bp rise in both long-term bond yields and Bank Rate expectations (priced 5 years forward) would be enough to fully eradicate the Chancellor’s headroom. We’re pretty close to that. And that’s before we account for any indirect hit to growth that higher borrowing costs might entail.

That doesn’t mean the recent rise in yields will have a huge impact, big picture. But two things can be true at once, and the Chancellor’s headroom could still be easily wiped out, simply because there was barely any in the first place.

UK and US 10-year bond yields (%)



Source: Macrobond

Is it going to be tough for the UK Treasury to meet its fiscal rules?

Technically speaking, no. In the run-up to the March budget statement, the Treasury will privately receive feedback from the OBR on whether or not it has run out of headroom. And if it has, it will have to make changes accordingly. No Chancellor is going to stand up and concede that it has run out of fiscal space.

But change is not as difficult as it sounds. Remember the fiscal rules are based not on actual budget deficits/surpluses right now, but where they’re projected to be in five years’ time. That allows for plenty of creative accounting about what the future holds.

In the aftermath of the 2022 ‘mini-budget’ crisis, the then-Chancellor Jeremy Hunt won round investors and the OBR back by promising big real-term spending cuts to various government departments in 3-5 years’ time. Three years on – 2025 - and the reality is quite the opposite. Real-term spending is set to increase, by a lot.

The Treasury is likely to do something similar now if it needs to. It has already signalled it would prefer to deal with lower fiscal headroom with spending cuts rather than tax rises. The lesson from 2022 is not to be fooled into thinking that will necessarily imply dramatically lower spending in the next financial year. More likely, the heavy lifting will come by paring back spending plans in future years, which ultimately may never materialise.

Will markets be OK with that and will gilt yields stay elevated?

Meeting fiscal rules on paper is one thing. Convincing markets that it's enough is quite another, particularly in a year where fiscal deficits are under greater scrutiny globally. Just look at the US or France.

Much will depend on the state of global bond markets around the time of the Spring Statement in March. But investors may be tempted to focus less on the OBR's analysis and the fiscal rules and put greater emphasis simply on bond issuance. The fact is that gilt issuance is expected to be perilously close to £300bn in the current fiscal year and the same again in the next, according to the Debt Management Agency remit.

For the time being, though, gilt yields will continue to get their cue from US interest rates, and thus, the next move will likely come from US economic data and Trump's policy actions. In our view, US rates can still edge higher, and we even foresee that the 10Y US Treasury rate could drift above 5% later this year. This would keep gilt yields elevated for the time being. For those yields to make a structural move lower and disconnect from the US, markets would need to become more convinced about the Bank of England's room for rate cuts. However, for this, inflation data would first need to show a series of better numbers.

Will we see further tax hikes announced in 2025?

Regardless of whether markets take a dim view on the forthcoming Spring Statement, any tweaks to future spending plans may not buy the Treasury a huge amount of time, anyway.

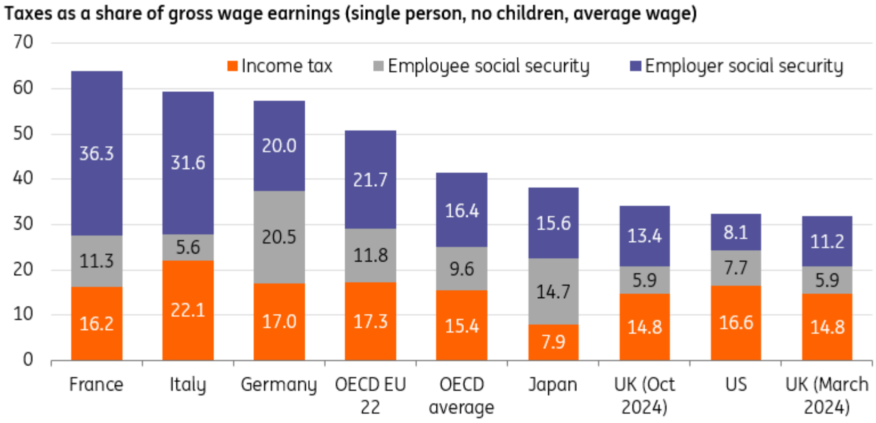
Real-terms per capita spending is budgeted to grow by 2.5% in the next fiscal year but by less than 1% in each subsequent year. Real-term investment spending is also projected to fall each year later this decade, albeit after substantial near-term rises. How realistic all of that is, particularly if those plans are pared back further in March, is questionable.

The Chancellor will hope that some of the government's other plans, for example on planning, will convince the OBR to upgrade its growth forecasts and buy the Treasury more breathing room.

But that might be a struggle, and at some point, most likely in the Autumn, the Chancellor is going to need to find more money. Tax rises look inevitable, especially if the Treasury is met with other adverse forecast changes from the OBR, further reducing the headroom available. The challenge is that much of the low-hanging fruit has been picked in the October budget last year. And remember, the Chancellor has ruled out changes to the major revenue-raisers such as income tax or VAT.

The path of least resistance might be to implement a further rise in employers' National Insurance (social security). Despite the big rise that's coming into force in April, employer social security payments will still be well below the European average as a proportion of an average salary, according to OECD data. Remember, too, that the tax burden – revenue as a share of GDP – is also lower in the UK than in many other European countries. That offers more obvious scope to lift taxes if needed, albeit at a potential cost to the economic growth the Treasury desperately needs.

How UK employee taxes compare globally



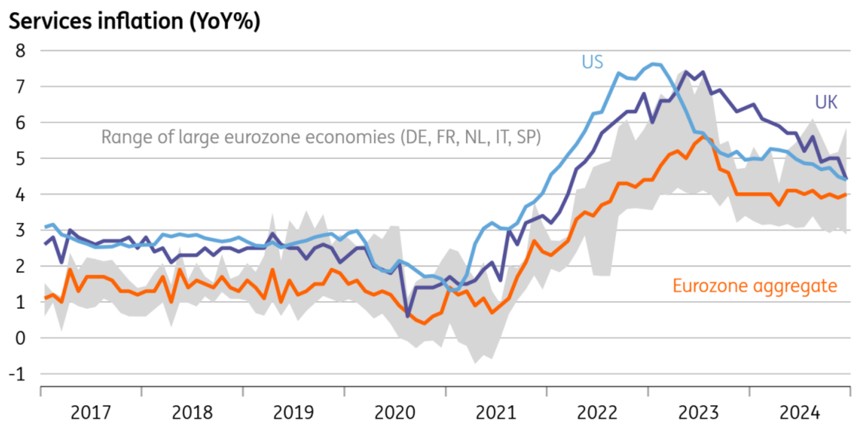
Source: OECD, ING calculations

UK figures are calculated by ING. OECD data for 2023 has been adjusted to account for National Insurance changes in November 2023, March and October 2024. All other countries assume no other changes since 2023

Is the UK's inflation problem really worse than everywhere else?

Aside from the UK's fiscal predicament, at least some of the recent surge in UK yields can be traced back to inflation. But the argument that the UK is worse off here is becoming less and less convincing. Services inflation, the Bank of England's central focus, is no longer an outlier at 4.4%. It's now similar to both the US and Germany.

UK services inflation is no longer an outlier



Source: Macrobond, ING calculations

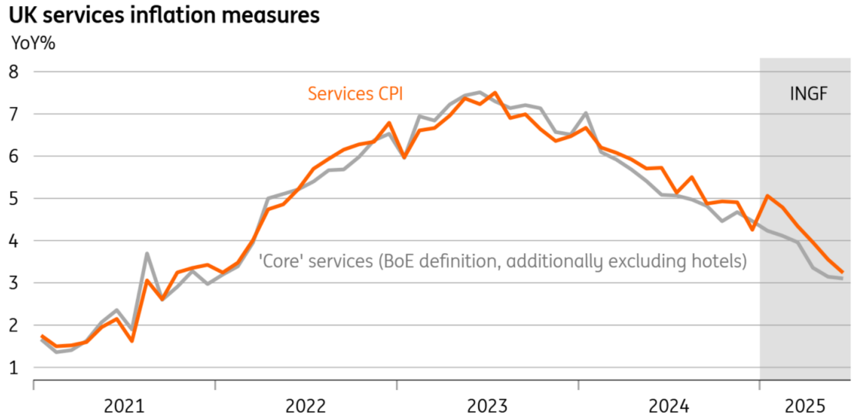
Admittedly, that's set to rise back up to 5% or above in January's data. Last month's drop was helped by airfares, which failed to properly account for Christmas price hikes. But that's noise, and our favoured measure of "core services "inflation, which strips out volatile/less relevant services (including rents), has been showing consistent progress. This gauge is at 4.5% and looks set to fall to 4.2% at the next reading.

We expect that core measure to fall below 3.5% by the spring. Remember that large swathes of the services basket are subject to annual April price hikes. Owing to lower headline inflation, these should be less aggressive than at the same point last year.

One major caveat: this process has proven to be unpredictable. Big surprises in the April inflation figures, released in May, drove some of the biggest market moves of the year in both 2023 and 2024.

Still, if we're right about the trend, then we think the Bank of England can become more relaxed as the year goes on.

Underlying services inflation set to fall further in the spring



Source: Macrobond, ING

Core services index excludes airfares, package holidays, rents and education. Calculated by ING

How many times will the Bank of England cut rates in 2025?

Given our view on inflation, we think the BoE will cut more aggressively this year than markets now expect. The swaps market is pricing 65bp of cuts by year-end; we expect 100bp.

That's less than we'd thought before; we still think rates will get to 3.25%, but the journey will be more gradual. We expect 25bp cuts per quarter, including in February.

Could it still end up moving faster? Definitely. Comments from Alan Taylor last week, one of the three committee members to vote for a rate cut in December, suggested that a more aggressive cycle is a distinct possibility if the inflation data continues to move in the right direction and/or the growth outlook turns out weaker. He may be a relative dove, but we doubt his views are that dissimilar to the more centrist committee members.

Is UK growth likely to underperform in 2025?

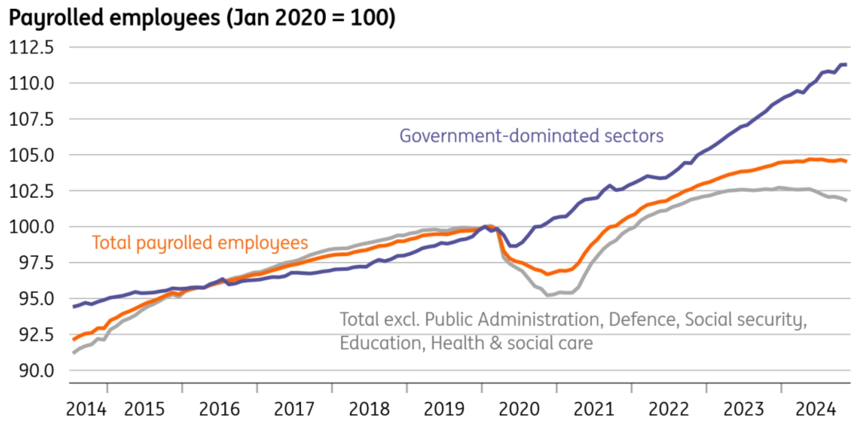
UK growth massively outperformed initial forecasts through 2024. But that looks like a trickier feat this year, with expectations already high.

Higher spending from October's budget will lift growth, not least because much of it will end up directly in wages. But will that be enough to generate 2% growth this year, as the OBR is forecasting? We're not convinced, not least following the recent run of lacklustre activity data. We're forecasting 1.4% for 2025 growth.

The real wild card though is the jobs market, where some cooling is already underway. Just look at vacancy rates, which are below pre-Covid levels in most sectors, or payroll-based employment, which fell by almost 1% in 2024, once government-heavy sectors are stripped out.

A material rise in layoffs, perhaps in response to the major tax hikes on those same payrolled employees, would dramatically lower 2025 growth forecasts. Nobody is expecting big rises in unemployment right now, data-quality issues aside.

Employment has gradually fallen, once government-heavy sectors excluded



Source: Macrobond, ING calculations

What does this all mean for sterling?

None of this is good news for sterling. While this is not demanding as much of a sovereign risk premium in the pound as was seen back in September 2022, the implications for the UK fiscal/monetary mix are sterling negative. As above, it looks like the Chancellor will probably have to tighten fiscal policy – a move that should push on the open door of a market underpricing this year's BoE easing cycle.

We have recently cut our sterling forecasts and now see EUR/GBP ending the year at 0.85 and 1.19 respectively. If anything, those downside sterling adjustments may be too conservative.

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