High yields and middling expectations

Summary
- Gilts have long been a mainstay for pensions, but their lustre has lacked polish recently.
- High yields at the end of 2024 sparked uncertainty and the wider consequences could yet be felt.
- The issues affecting gilts are partially specific to the UK, but more widely government bonds have had a bumpy ride.
- The new US administration could bring about greater volatility, which could affect gilts, but the impact is uncertain.
- While the markets recovered, repercussions of the gilts crisis following the Truss government's mini-Budget can still be felt.

Gilts have long been a mainstay of pension investment strategy. But since the crisis in 2022, have attitudes shifted? We take a look at the current state of play for this traditionally solid asset class

Gilts have always played a pivotal role in pension funds' investment, conventionally providing a haven, a solid and reliable asset and a foil to comparably more erratic equities. But recent years have clearly demonstrated that even a gilt-edged asset class can struggle; ever since the crisis that ensued after the Budget delivered by Kwasi Kwarteng for Liz Truss's short-lived government in 2022, the performance of UK gilts has been closely scrutinised.

When then-UK chancellor, Kwasi Kwarteng, announced a list of unexpected measures, the markets spiralled; the UK 30-year gilt, notably, spiked 120 basis points over three days. Things may have been calmer since that period of crisis but, inevitably, a certain level of sensitivity remains around gilts, and sudden movements in this traditionally dependable sphere provoke reactions.

The end of 2024 saw a sharp increase of yields, for example, and shifts such as these have consequences, explains Payden & Rygel senior vice president, Finn Nobay. "The direct and immediate consequence is higher borrowing costs to the UK government and the marking down in the value of current holdings for gilt investors," he says.

But beyond immediate consequences, Nobay adds: "The longer gilt yields remain at elevated levels, the greater the pass through and consequences to the broader economy."

Some argue that the surge in gilt yields is evidence of deeper concerns around the UK government's policies. Indeed, RBC BlueBay Asset Management portfolio manager, Neil Mehta, says that the new government's autumn Budget triggered the current episode. He adds: "The new government promised economic stability and growth but, instead, investor confidence in the gilt market has been hit again, just like previous episodes in late 2022, with the Truss Budget, and mid-2023, with the hyperinflation scare."

As a result, Mehta warns: "The risk premium the market attaches to UK assets could linger on for longer this time, given the government's reluctance (thus far) to change course following last autumn's Budget, which sparked the latest episode."

He adds: "Given our pessimistic view on the inflation and growth backdrop, we think gilt yields will remain higher for longer, with the risk of coming to loggerheads with government policy."

Relief but not reprieve

There are some areas of the economy that have brought a level of respite, such as lower-than-anticipated inflation. But will this really bring relief, and if so, will that last?

Nobay says: "The softer December inflation print in the UK did bring relief to the gilt market, as it brings the case forward for another Bank of England cut in February and increases hopes the data will embolden the MPC to become more active in the current rate cutting cycle."

What's more, Nobay adds: "The relief

was also fortunately timed, as gilt yields appeared to have hit the threshold where higher yields were feeding into sizeable currency weakness." A dynamic such as this can cause concern, he explains, as the price action can quickly become a vicious cycle, "without imminent corrective action".

Similarly, softer than expected inflation in the US has also led some to believe that gilt yields have further to fall. "However, this type of 'relief' doesn't fix any of the underlying issues concerning the UK fiscal path," Nobay says. "So, if we were to see a renewed period of global bond market weakness, then it's likely gilts will again look vulnerable."

Russell Investments head of fiduciary management, Simon Partridge, echoes that cautionary tone, citing issues closer to home: "Significant uncertainty remains regarding the immediate outlook for the UK economy and the Bank of England's ability to cut interest rates. With rates remaining high, the cost of borrowing will have an impact on the government's budgets leading to spending cuts and/or further tax rises."

Indeed, according to Mehta, it's risky to assume difficult times are over. "Any *[sense of]* relief is a sign of complacency," he says. "Disinflation (a decrease in the rate of inflation) has occurred, but from high levels."

In fact, Mehta says, inflation in services, considered 'sticky' because of its slower adjustments to changes in supply and demand, has fallen to 4.4 per cent year-on-year, which is "not compatible with underlying inflation returning to 2 per cent on a sustainable basis".

Rents, too, are rising apace, while Mehta fears the government's national insurance increases on businesses could feed lead to higher selling prices. Add in likely above-inflation increases in utilities, council tax and phone bills, and the picture arguably looks concerning.

External forces or internal issues?

For Nobay, the challenges faced by gilts are, to a certain extent particular to the UK. "The gilt market is facing the challenge of financing a glut of supply at a time of quantitative tightening. The UK is not alone here, and this is an issue for most developed sovereign debt markets," he says.

"However, the UK's issues are potentially more acute than others. As well as maintaining a sizeable fiscal budget deficit, the UK also runs a substantial current account deficit. This twin deficit makes the UK market vulnerable to global risk sentiment, and with the economy struggling to generate meaningful growth, while inflation remains a concern, sentiment towards the gilt market appears fragile," he adds.

"The sharp rise in UK gilt yields has been driven by domestic fiscal policies and global economic dynamics"

Partridge, too, says that much of the UK gilt's markets issues are homegrown. "The sharp rise in UK gilt yields has been driven by domestic fiscal policies and global economic dynamics," he says. "The UK government's last Budget introduced the largest tax hikes in decades, alongside substantial borrowing plans, and heightened market concerns." This, he says led to a significant increase in 20-year gilt yields (up 60 basis points to 5.1 per cent). Other domestic challenges include sluggish economic growth and reduced tax revenues, as well as persistently high inflation, all of which "have compounded the sell-off in UK gilts".

However, he adds: "International factors also played a role, with heightened global inflation fears – largely influenced by US policy expectations following the election outcome – pushing global bond yields higher and further pressuring UK borrowing costs."

Indeed, he says: "The gilt markets experienced an additional sell-off, primarily led by US Treasuries. This trend may have further room to run, as rising real yields reflect uncertainty surrounding the Trump administration's policy agenda, even as US breakeven inflation rates remain stable. Global markets are likely to continue to feel the effects, as Trump's policies – such as efforts to curb immigration, cut corporate taxes, and impose higher tariffs – create competing economic forces that could drive further volatility."

Future imperfect

The future for gilts, that traditional harbour in a storm, may not be quite as reliable as it once might have been, Mehta says: "Gilt investors are more paranoid since 2022, as *[the crisis]* highlighted some key challenges the UK faces, in terms of getting its finances in order in a higher interest rate environment. This is reflected in higher volatility, and lower liquidity in the gilt market. Looking ahead, there is a risk that a day of reckoning for gilts could finally spark a change in policy direction could still be ahead in the coming months."

And, Nobay adds: "The gilt market eventually recovered *[post-2022 crisis]* but the market has a short-term memory, so events in 2022 likely have impacted liquidity and exaggerated moves in the recent weeks. We don't envisage turmoil of the same magnitude in the near future; the inflationary environment has improved considerably, central banks are cutting rates albeit it gradually and leverage has been taken out of the gilt market."

Nevertheless, says Nobay: "Gilts will remain vulnerable to further global bond market weakness until the underlying issues of deteriorating debt dynamics, through excess fiscal supply and low growth are addressed."

Written by Sandra Haurant, a freelance journalist