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It's always darkest before the dawn

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It feels like a long time since a UK government made decisions that left the country feeling more optimistic. In fact, since the financial crash in 2008, successive governments have attempted to square the circle of rising debt and falling living standards with short term policies aimed to their electoral base. Be it low interest rates propping up the housing market, or higher benefits for people out of work with medical conditions, governments have stumbled from pillar to post in the search for an answer.

Rising oil prices may be contributing to a second inflation shock for the UK in five years and may well be the catalyst which forces the government to make hard choices in setting the longer-term policy.

Gilt yield dynamics have become an increasingly binding constraint on the UK government's fiscal planning framework. At a practical level, higher yields translate directly into higher debt servicing costs, but the more subtle challenge lies in the erosion of forward visibility. When the term structure steepens or shifts unpredictably, it complicates the Treasury's ability to anchor medium-term expenditure assumptions with any degree of confidence.

In a low-yield regime, refinancing risk is muted and the marginal cost of issuance remains stable enough to support multi-year spending commitments. By contrast, a rising yield environment introduces convexity into the fiscal outlook: small upward moves in rates can disproportionately increase projected interest outlays, particularly given the UK's relatively short average debt maturity and significant stock of index-linked gilts. This creates a feedback loop where fiscal headroom is persistently revised down, even in the absence of discretionary policy changes.

From an investment management perspective, the issue is not simply the level of yields but their volatility and correlation with inflation expectations. As yields reprice alongside inflation uncertainty, the government's cost base becomes more pro-cyclical, tightening precisely when fiscal support may be most needed. This undermines countercyclical policy credibility and forces a more reactive, rather than strategic, approach to expenditure planning.

Moreover, elevated yields can crowd out public investment by reprioritising spending toward mandatory interest payments. The opportunity cost becomes increasingly visible: capital projects with long-dated payoffs are deferred in favour of near-term fiscal stabilisation. Over time, this risks entrenching a lower growth equilibrium, which in turn feeds back into higher risk premia demanded by investors.

In this context, gilt yields function not merely as a market signal, but as an active constraint on sovereign optionality, narrowing the government's capacity to plan, commit, and invest with conviction. The 10-year borrowing cost for the UK government moved through 5% this week, a yield not seen since before the financial crisis, when the UK economy was growing at an annualised rate of close to 3%. This yield, during a period when the UK is growing at 1%, will force our political classes to make some hard decisions on spending and the future structure of our economy. A difficult adjustment, perhaps, but not without the prospect of something better on the other side.

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