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UK gilt yields and the economy

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We hold UK Gilts in the Stabiliser because they have historically done a specific job. When equities fall, government bonds cushion the blow in a way few other assets can be relied on to do. That job matters as much as ever today, when we have to weigh the longer-term problems facing the UK economy against the shorter-term case for holding these bonds in your portfolio.

So why do we still hold them, and why specifically the ones that mature in under five years?

Start with what a gilt yield actually is. It is the interest rate investors demand to lend the government money today. That single number carries a lot of information. It reflects the returns available elsewhere, the path the Bank of England is expected to take on interest rates, and the compensation investors want for the inflation and risk they are taking on. In other words, a gilt yield is the market's running verdict on UK growth, inflation, and creditworthiness, with the US Treasury market increasingly pulling on our own borrowing costs too.

Growth is the first driver, and it works through the "real" component of the yield, which is the technical term for the expected return *after* the effect of forecast inflation. When investors expect stronger growth, they expect more demand for credit, better investment returns from other investments, and probably tighter policy from the Bank of England, all of which push real yields up. Weak growth normally does the opposite, pulling yields down as demand for credit falls and rate cuts move into view. But there is a twist. When weak growth sits alongside heavy government borrowing, as it does in the UK today, investors start to worry that a stagnant economy will make the debt harder to shrink relative to national income. The UK's persistent productivity problems add to that pressure rather than relieving it.

The effect of forecast inflation in the economy has a powerful effect on what we call longer duration bonds. Anyone lending money for ten or thirty years wants to be compensated for inflation eating into what they get back. UK inflation (services inflation in particular) has stayed stickier than in most other advanced economies, which limits how quickly the Bank of England can cut rates. The market prices that stickiness straight into gilt yields.

Then there is creditworthiness, which shows up as the risk, or term, premium. The UK is still a highly creditworthy sovereign with one of the world's deepest bond markets. But investors ask for more compensation when public debt, borrowing plans or fiscal policy look less certain, and the past few years, from the 2022 mini-budget onward, have made domestic risk factors harder to ignore. That premium can push yields higher even when the market expects the Bank of England to cut rates.

Put it together and UK gilt yields sit above those of the other G7 economies for a mix of reasons. A higher term premium, fiscal and credit risk, and a structurally higher neutral interest rate. But inflation and growth are still doing most of the work, sticky inflation keeps expected rates elevated, and weak, uncertain growth raises the return investors demand to fund the UK's borrowing.

This is where maturity matters. Gilts maturing in under five years are less exposed to those long-term worries about growth, inflation and creditworthiness, because their prices track the near-term path of Bank of England rates rather than decades of uncertainty, so shorter-dated gilts carry a much smaller term and fiscal-risk premium. Gilts remain fundamentally different from growth assets like equities, which is exactly why we expect them to keep doing their job as the counterbalance in your portfolio, and it is why, in the strategies we manage, we hold the shorter end of the curve rather than reaching for extra yield further out. Less uncertainty means less price volatility, and for the ballast in a portfolio, that stability is the whole reason it is there.