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UK Gilts Face Growing Risk of Market Breakdown

July 23, 2025
— Categories: Finance

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The UK's public finances are teetering on the edge of a crisis, driven by political paralysis and an inability to enact critical fiscal reforms. As Peter Siller and Emma Moriarty, analysts at a leading investment firm, recently noted, "A bond market crisis is now the most likely catalyst to force the painful spending cuts needed to stabilise the nation's finances." This stark warning comes as the Labour government struggles to navigate a treacherous fiscal landscape, with rising debt and interest costs exposing deep vulnerabilities.

The current government's failure to push through welfare reform, a key plank of its fiscal strategy, underscores a broader issue: a lack of parliamentary support. Jean-Claude Juncker's observation during the euro area debt crisis that politicians know what needs to be done but fear the electoral consequences feels acutely relevant. The Prime Minister and Chancellor face a similar dilemma, unable to secure the votes needed for meaningful change. This political gridlock has fuelled market unease, with yields on long-term gilts used as a barometer of confidence in public finances signalling growing fears of fiscal dominance, where government borrowing dictates interest rates.

The UK's fiscal challenges are compounded by a departure from traditional economic principles. John Maynard Keynes advocated countercyclical fiscal policy, using deficits to avert economic collapse during downturns. Yet, despite steady economic growth, the government's fiscal stance mirrors that of a recession, with no clear reference to the economic cycle in the Chancellor's fiscal rules. This unsustainable approach has led Siller and Moriarty to revise their outlook: "We initially believed fiscal reform could avert a debt crisis. Recent events suggest reform will only follow a crisis."

Addressing the UK's fiscal woes requires bold action, but options are limited. Raising taxes further is impractical, as the government has repeatedly pledged to shield working people from additional burdens. Instead, spending cuts are inevitable. The Office for Budget Responsibility (OBR) has flagged social security reform as a priority, making it a prime candidate for consolidation. Supply-side reforms are equally critical. Streamlining the planning system to boost housing and infrastructure delivery, alongside tackling dismal public sector productivity partly attributed to the civil service's reluctance to return to office-based work, could unlock growth.

However, proposals like a wealth tax risk stifling economic activity for uncertain revenue gains, undermining the growth needed to ease fiscal pressures. Without decisive reform, the UK's small, open economy, lacking the global reserve currency status of the US or euro area, faces a heightened risk of a bond market shock, reminiscent of the turmoil under Liz Truss.

The looming threat of a gilt market breakdown demands a cautious approach. Siller and Moriarty advocate a defensive stance, noting, "We are underweight risk assets due to concerns over stretched US equity valuations and a weakening macroeconomic outlook." Their multi-asset funds prioritise index-linked government bonds and cash reserves to

reduce volatility and hedge against inflation. Until meaningful fiscal reforms emerge, investors must brace for heightened uncertainty in UK markets.

The timing of a potential crisis remains uncertain, but the long end of the gilt curve will hinge on restoring market confidence. Without swift action, the UK risks a rapid erosion of trust in its fiscal credibility, with far-reaching consequences for sterling and the broader economy.