Economic Research Unit

Economics Weekly

Bank of Ireland

Sterling under pressure despite rising gilt yields

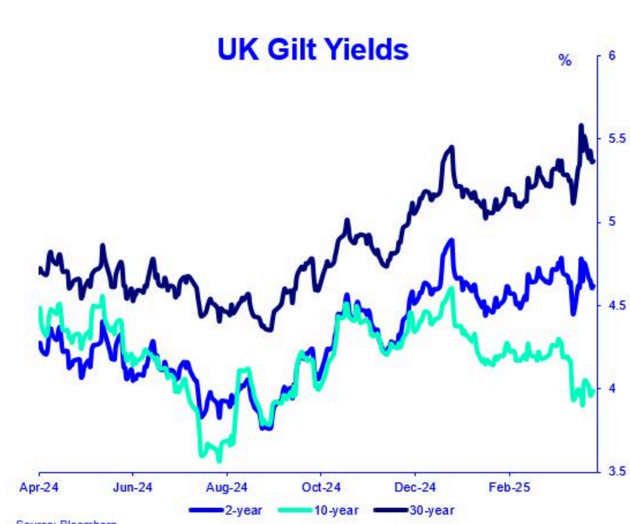
Sterling has lagged the euro and other currencies in recent weeks, during the risk-off moves in financial markets as investors have reduced their dollar exposures. This is despite a notable steepening of the UK yield curve, 30-year gilt yields now at 5.35%, their highest level since the late-1990s. This shows UK assets have failed to benefit from any perception Britain is relatively insulated from a global trade war. True, the Bank of England is expected to cut rates to 3.75% by end-2025 to support the economy. However, investors remain focused on the sustainability of the UK's public finances. Specifically, that plans to gradually rein-in public sector borrowing from 4% of GDP appear to rely on unrealistic assumptions on spending and optimistic projections for GDP growth. So sterling is unlikely to see a sharp rebound against the euro in the near-future, absent a far broader recovery in financial market risk appetite.

Sterling lags behind: Sterling has depreciated sharply against the euro through April, the exchange rate at 85.9p this morning, having started the month at 83.5p. Despite appreciating to $1.32 against the dollar, sterling has lagged behind other currencies as risk-off moves following the imposition of US tariffs led investors to move away from dollar assets. UK assets clearly haven't benefitted from any perception Britain will be relatively insulated from a global trade war. Rather, as in the US, concerns around the UK's fiscal position and functioning of the gilt market persist.

Expectation for rate cuts put downward pressure on short-end of the curve: Options are currently fully pricing in three 25bp cuts from the the Monetary Policy Committee by end-2025, beginning at the next policy meeting on May 8th, and with a 45% probability of a fourth to 3.5% by March 2026. News this week that private sector regular earnings growth slowed to 5.9% in February and CPI inflation 2.6% in March, have encouraged this view, putting downward pressure on the short-end of the curve. Hence, 2-year gilt yields have fallen by 15bps since the beginning of April, now at 4%.

Concern around UK's fiscal sustainability persist: Chancellor of the Exchequer Rachel Reeves' March Fiscal Statement did little to rein-in the public finances. Public sector borrowing of 4% of GDP is expected in budget year 2025/26, forecast to gradually reduce to 2% of GDP by 2029, but relying on spending assumptions the Institute for Fiscal Studies (IFS) have deemed unrealistic and a pick-up in GDP growth to 1.9% in 2026. The Office for Budgetary Responsibility (OBR) has warned poor productivity performance could hinder the UK from achieving this expected rebound in GDP growth.

Long-end of the curve driven upwards: UK 10-year and 30-year gilt yields peaked on April 9th at 4.78% and 5.63% respectively. Though falling back since then, they remain well above the levels seen during the fall out from Liz Truss' '*mini-budget*' in 2022. The pick-up in term premia that investors now demand for holding duration on UK gilts has meant the 30-year yield is now at its highest level since the late 1990s, steepening the curve. Such has been the market volatility, the Bank of England put-off an auction of long-term gilts, due on April 14th, as part of its quantitative tightening (QT) programme.



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