

Views from the LDI Desk

Pre-Budget UK Outlook: Turning the corner?

In this piece, ahead of the budget on 26th November 2025, we look at the macro, fiscal and technical influences on the gilt market to assess both the bull and bear case for gilts as we run into year end.

The macro mix is still challenging for the Bank of England (BoE): inflation is drifting sideways near 4%, although the recent downside miss with CPI holding at 3.8% was helpful. Meanwhile the labour market continues to soften and savings rates (albeit often revised) have continued to climb. Wage growth is easing but likely remains inconsistent with a clean return to 2% inflation given weak productivity.

The fiscal story has continued to deteriorate since the last fiscal event in the spring, but there are signs the government is grasping the challenge. There are growing expectations that the Office for Budget Responsibility (OBR) will downgrade productivity assumptions by up to 0.3%, which mechanically shrinks fiscal headroom (to the tens of billions) and pushes issuance risks to the upside.

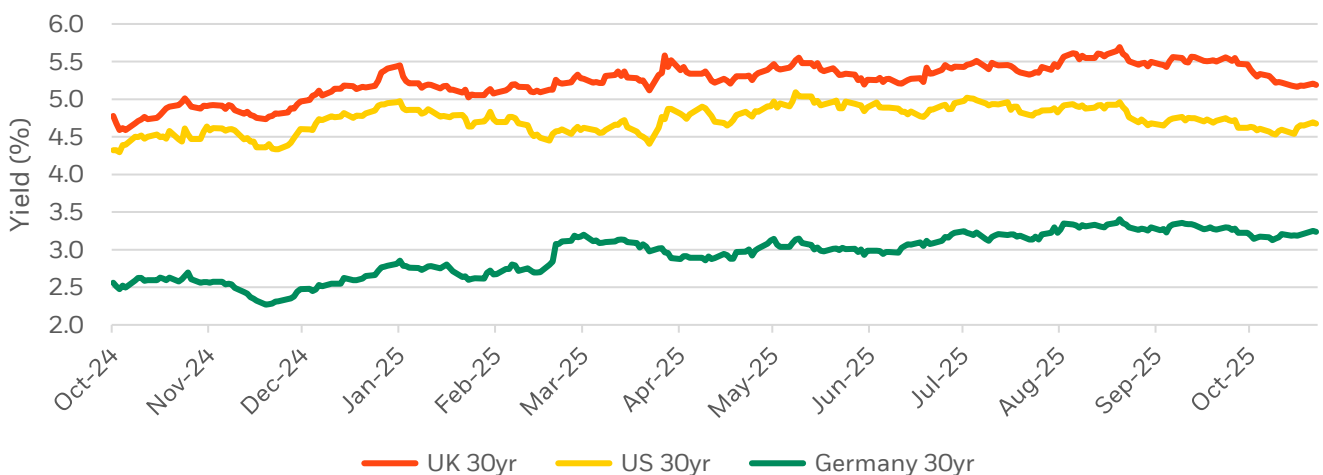
We believe the constant market and press focus on the fiscal headroom leaves the Chancellor tempted to make a bolder move on re-establishing headroom and recent messaging from the Government has

placed an increasing focus on helping to battle inflation. When we look under the hood, the UK's primary deficit (excluding interest costs) is on a decent trajectory. Could this be the budget where the gilt narrative turns the corner?

Technicals (market jargon for supply and demand!) are in flux but turning a touch more supportive at the long end. The BoE has slowed Quantitative Tightening (QT) to £70bn over the next 12 months and will bias sales to short and medium buckets with a 40-40-20 split between the short, medium and long buckets. That lowers long supply just as the DMO has already pivoted issuance aggressively shorter. With recent changes to auction schedules and a skewing to shorter syndications, long dated gilt supply has dropped materially. Against this, with many schemes already well hedged, the last decade's relentless outright LDI demand is likely gone for good, with most schemes making small refinements to hedges.

Despite the headwinds gilts face, we think there are green shoots emerging for the bull case for gilts, having held a bearish outlook for the last 3 years or so. Given the shortening gilt issuance profile and recent indications from the Chancellor regarding support for the Bank of England's efforts to address inflation, is there potential for the current rally in long-term gilts to persist? Gilt yields still look attractive relative to other regions.

Global bond markets have rallied recently with gilts leading the way

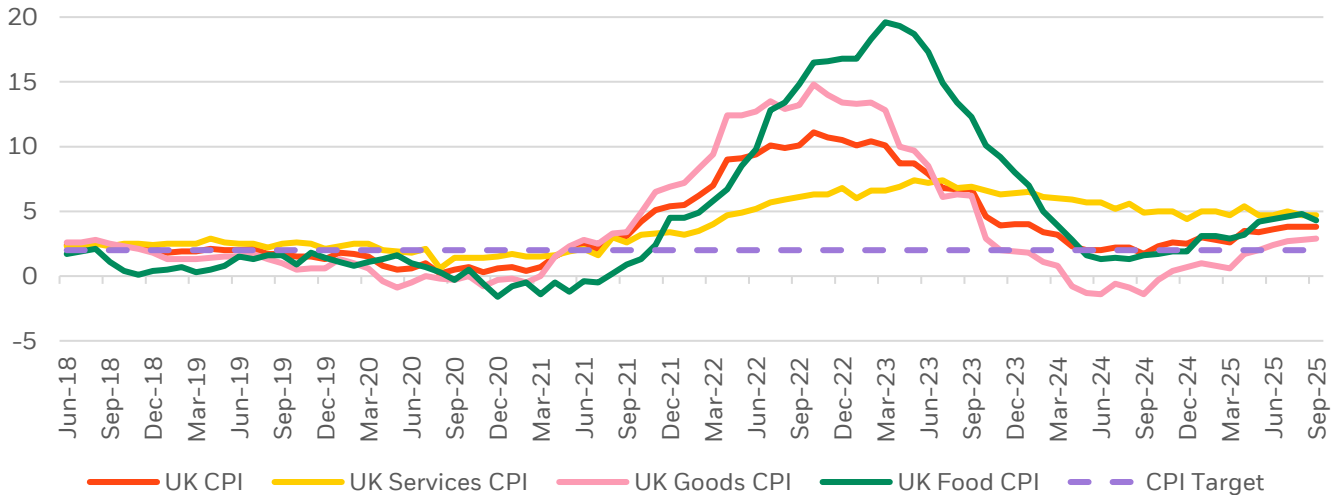


Source: BlackRock, Bloomberg. Data as at 3 November 2025.

1) Macro back-drop: sticky inflation meets softening labour market

Inflation has cooled materially from the peak, but the last mile is proving sticky. September CPI printed at 3.8% year on year, coming below market expectations of 4% and providing some relief, but with services inflation still elevated and core inflation easing only gradually. Reassuringly, food inflation, which had been accelerating, showed signs of cooling.

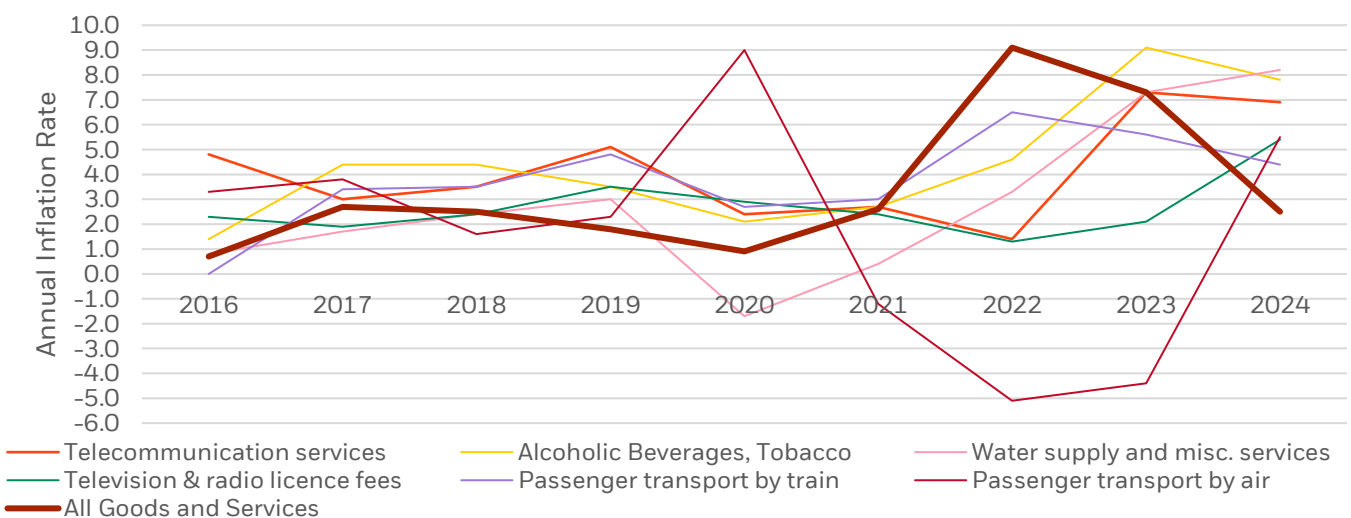
Inflation had been rising again, driven by food and sticky services



Source: ONS as of September 2025

In addition to the market, the BoE had also expected inflation to reach 4% again before a slow grind lower - September's downside surprise might mean this can be avoided. But the struggle to sustainably get inflation back to 2% in the UK in part reflects policy choices and a high share of index-linked items in the UK basket that embed persistence. With around 10% of the CPI basket either explicitly or indirectly linked to CPI, RPI or some other inflationary uplift, these indexed elements tend to propagate the shock and cause the time taken for this to dissipate to increase. This is where the fiscal and the macro begin to cross over, with it being within the Chancellor's will to adjust some of these items.

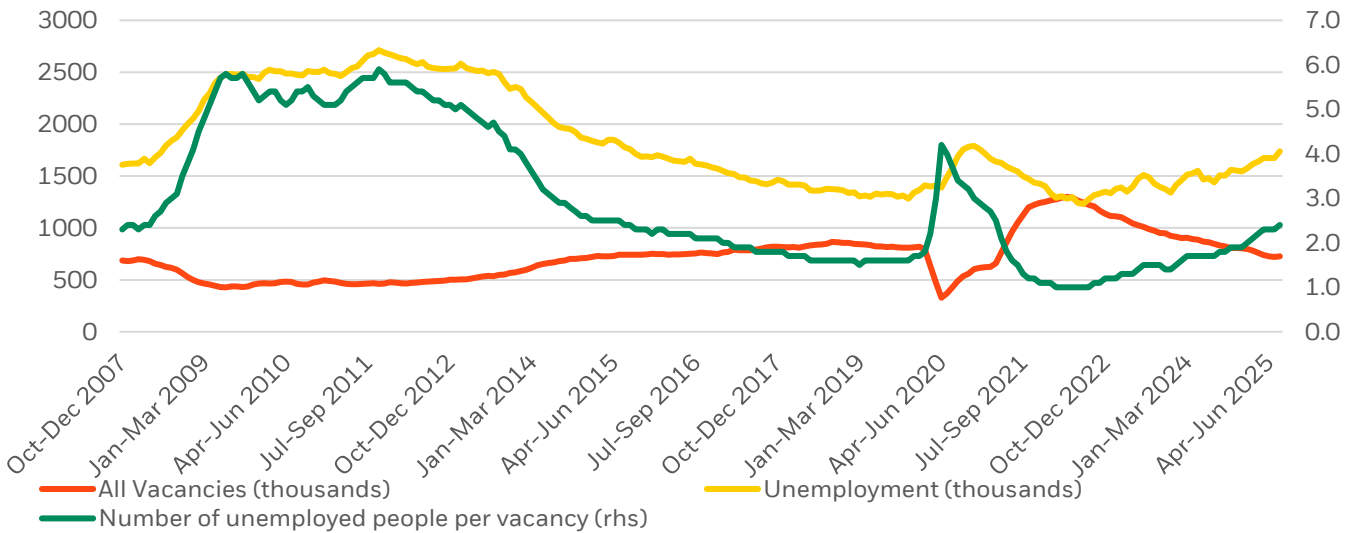
Indexed categories follow CPI with a lag, reinforcing a good proportion of the basket's persistence



Source: ONS as of December 2024

While inflation has given BoE hawks something to anchor on, the labour market is loosening at the edges. The unemployed to vacancy ratio has been trending higher and pay growth is decelerating from the highs, although at roughly 4.5–5% it remains too hot for comfort given the sub-1% trend productivity.

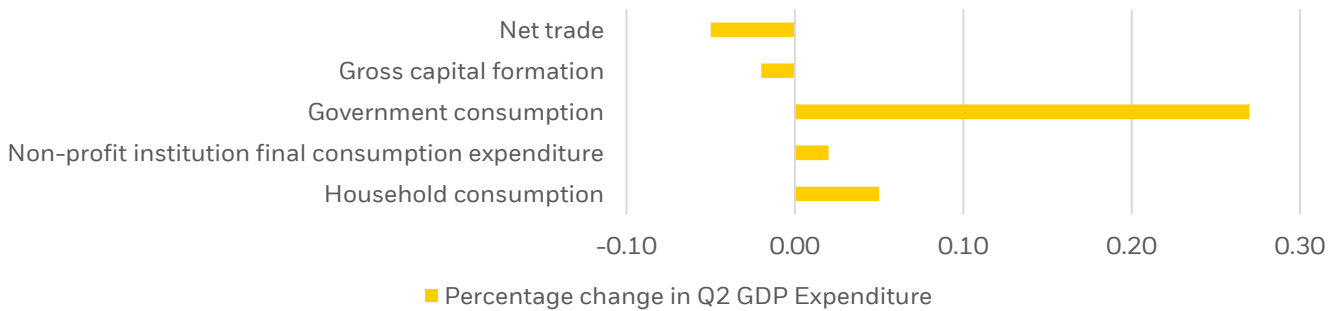
Labour market conditions have been gradually softening for some time



Source: ONS as of September 2025

Looking across the economy more broadly, growth is better than feared but hardly strong. Recent GDP prints have been helped by public-sector services, while private-sector momentum remains lacklustre. In fact, without increased government spending, the economy would barely be growing at all.

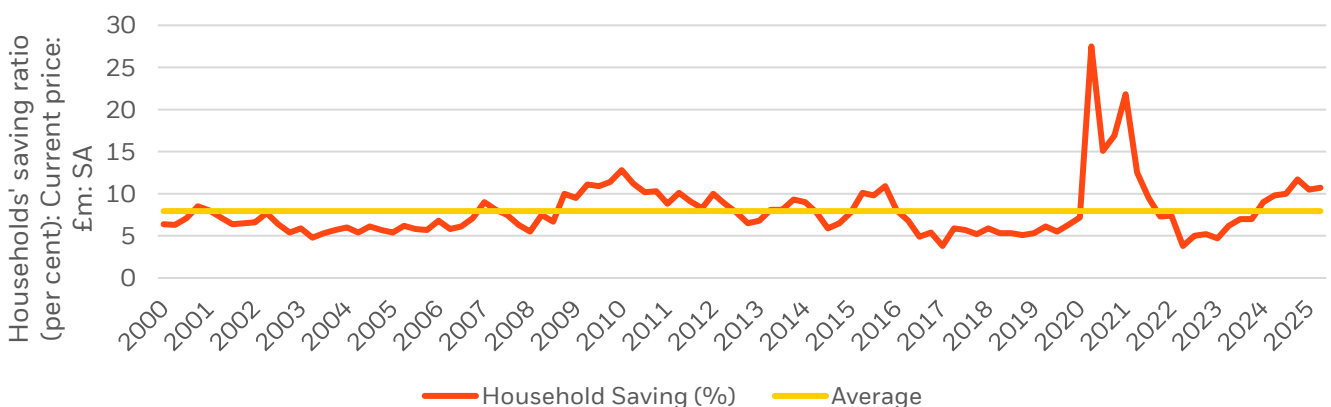
Q2 GDP Growth was heavily driven by Government expenditure



Source: ONS as of September 2025

Household saving rates have risen back toward post-GFC levels, consistent with consumer caution in the face of tax drag and mortgage resets. This can create a dampening effect on the economy by reducing consumption in the near term and reducing aggregate demand.

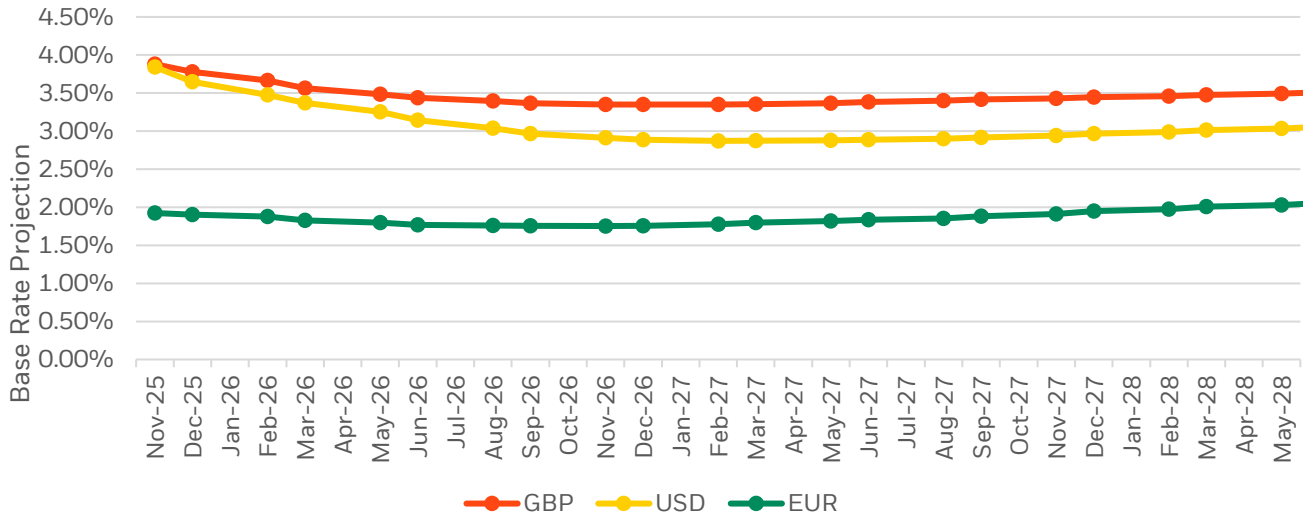
Household saving ratio is high indicating a cautious consumer



Source: ONS as of October 2025

This mix of sticky inflation and a weakening labour market with anaemic growth have left the BoE on a shallow and slow rate cutting path, with expectations of the terminal rate struggling to break meaningfully below the mid-3%_s. This has left sterling rates lagging other regions, at a great fiscal cost to the Government, given the base rate impacts the cost of funding BoE balance sheet assets and gilt borrowing rates.

Bank of England is forecast to be both slower and more careful in cutting rates



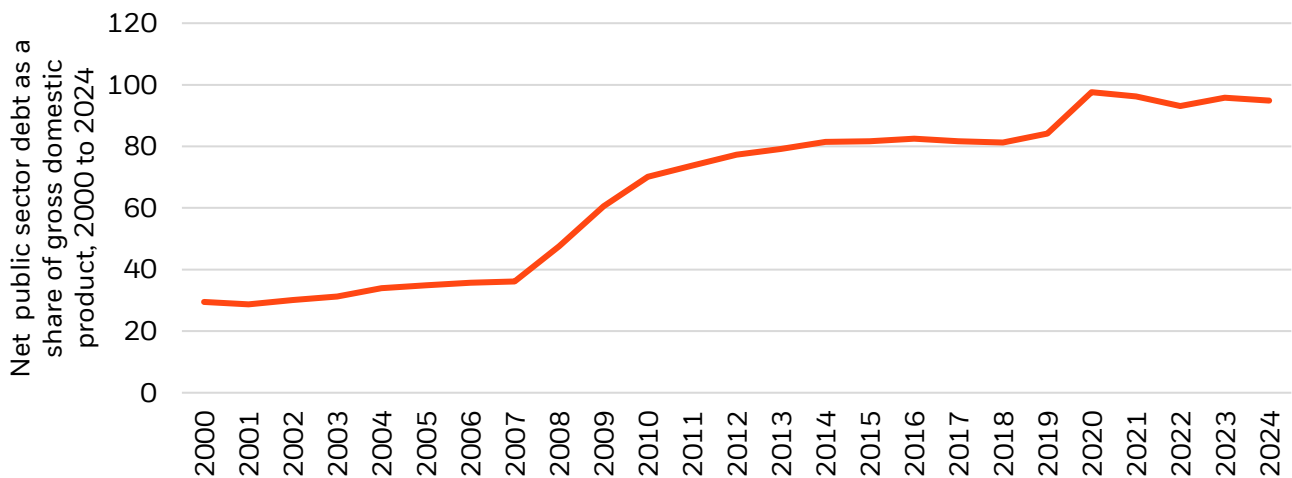
Source: BlackRock. Data as at 22 October 2025.

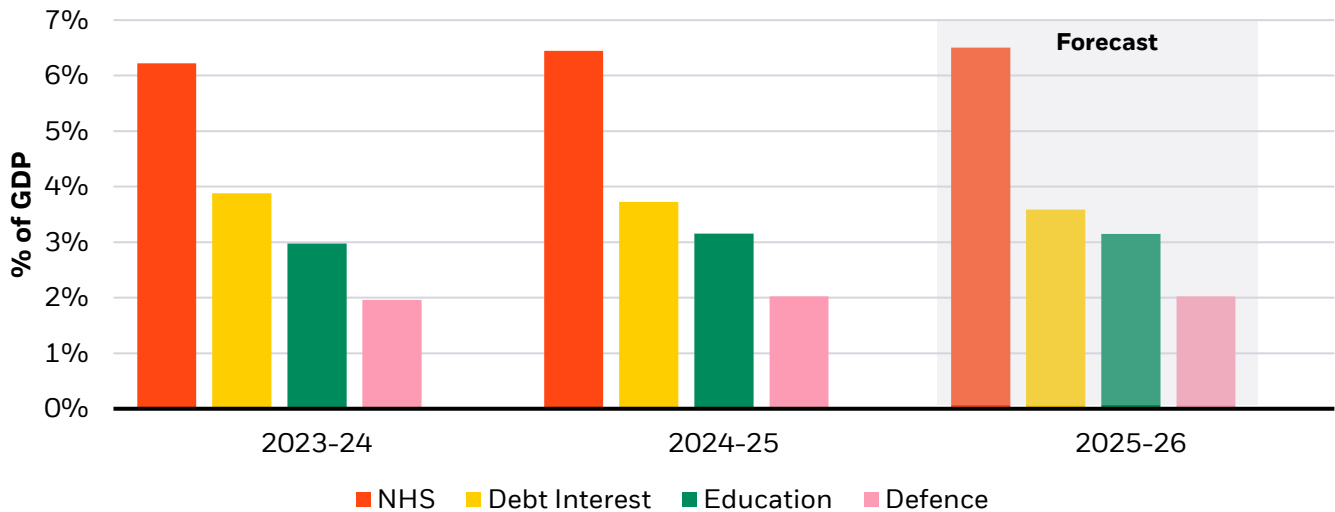
Fiscal and monetary policy are fundamentally entwined. While last year’s budget was inflationary through its spending and increases in taxes on employment such as employer NICs, this time could be different.

2) Fiscal set-up: rules can be met, but the hole is widening if productivity is marked down

It is easy to be gloomy on the UK’s fiscal position and outlook and this often feels like a national sport. Debt-to-GDP has grown substantially over the past two decades, while high interest rates on top of this debt burden mean debt interest is now one of the largest single spending lines on the Government’s ledger.

UK Debt to GDP close to record while interest costs have become a significant proportion of spending





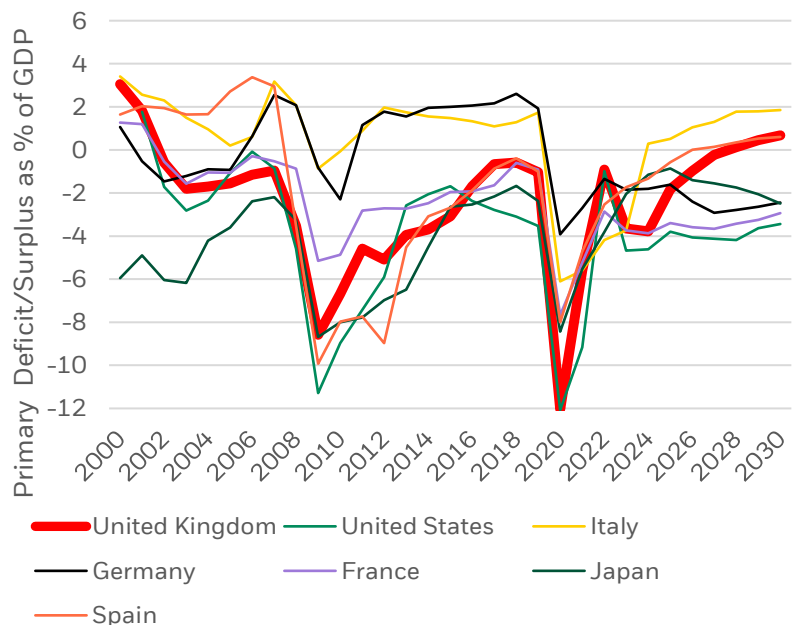
Forecasts may not come to pass. Source: BlackRock, ONS. Data as at October 2025.

The fiscal loosening in 2024 was big by post-2010 standards, helped by changes in how debt is measured shifting to Public Sector Net Financial Liabilities (PSNFL), which supports more public investment via financial vehicles but does not magic away borrowing needs.

However, relative to many other countries the UK is on a reasonable path to fixing its primary deficit, that is the deficit that exists once the cost of servicing debt is stripped out. Yes, this does rely on fiscal discipline around spending in later years of the forecast and yes, some of this spending control looks challenging. But compared to many other countries the path is far more sustainable. This is often missed in the relentless focus on the headroom and self-imposed fiscal rules.

UK forecast primary deficit path is much more favourable than many other major sovereigns

Country	Debt to GDP	Primary Deficit	Fiscal Trend
United Kingdom	95%	3.8%	↓
United States	98%	4.6%	→
Italy	127%	-0.3%	↓
Germany	50%	1.8%	↑
France	108%	3.9%	→
Japan	134%	1.1%	↑
Spain	102%	1.3%	↓



Forecasts may not come to pass. Source: IMF. Data as at October 2025. UK Forecast based on post March 2025 forecasts.

The cost of debt servicing could be helped through actions from the government that would aim to dampen inflation, for example a VAT cut to energy bills (currently 5%), which, based on its CPI weight, we forecast would reduce inflation by 0.24% over the next year. While this is a one-off impact, it could interact with indexed elements to lead to a more prolonged reduction in inflation, as well helping to manage inflation expectations and future wage rounds.

Other policies such as adjustments to hospitality VAT rates, changes to regulatory rules for water or telecoms could also be explored, but energy appears a relatively efficient, low cost and progressive approach.

Heading into the autumn Budget, we see three tensions:

- 1. Headroom vs reality.** Productivity downgrades likely to be in the region of 0.3% will have a significant impact on headroom, with expectations in the region of £15-20bn, even before this change headroom was narrow. When combined with other policy roll backs such as welfare reform and winter fuel, this may leave required fund raising to restore headroom in the region of £30-40bn.

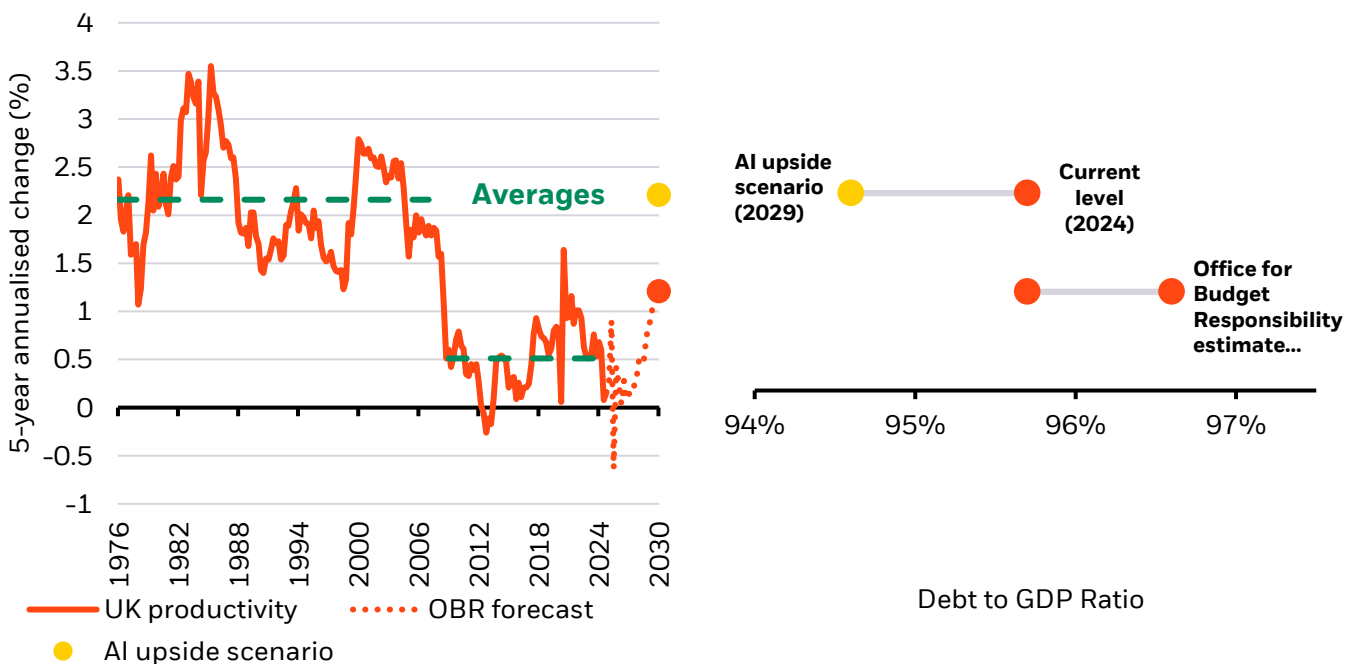
Survey from brokers	Headroom March 25	Current Headroom	Measures	Post Measures Head Room
Average	9.9	-21	-33	12
Low	9.9	-35	-41	6
High	9.9	-15	-30	15

Forecasts may not come to pass. Source: Broker estimates of Fiscal headroom and impact of various policy changes as part of the 2025 Autumn budget. Data as at October 2025.

- 2. Issuance vs fiscal rules.** The rules can be met on paper with investment classified as financial assets, but gilts still need to be issued to raise the cash to fund financial bodies. Relative to other G7 issuers, the UK is not the worst offender on deficits, but a credibility gap since 2022 still lingers and makes the market more sensitive to surprises.
- 3. Politics and composition of tightening.** Broad-based tax measures would be the cleanest fix, but the path of least resistance given manifesto pledges is often a patchwork of narrower measures that add uncertainty to outcomes and are harder for the gilt market to confidently swallow.

We hear a lot of optimism about AI as an offset to mooted productivity downgrades. While AI might help boost productivity, even generous estimates only get us back toward where the OBR had been assuming productivity to land. AI doesn't look like a productivity boom that solves all the Budget constraints.

AI productivity boost could improve outlook but they aren't a silver bullet to the UK's debt problems



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, Office for Budget Responsibility, July 2025. Note: Productivity is defined as output per hour worked. The chart shows the forecasted change in debt-to-gdp ratio in 2024-2029 under different GDP assumptions.

In addition, the UK is expected to experience a lower boost to growth from AI than the US, given the make-up of the economy, higher proportion of government led growth and constraints in the UK electricity grid in terms of electricity generation, connections and high costs.

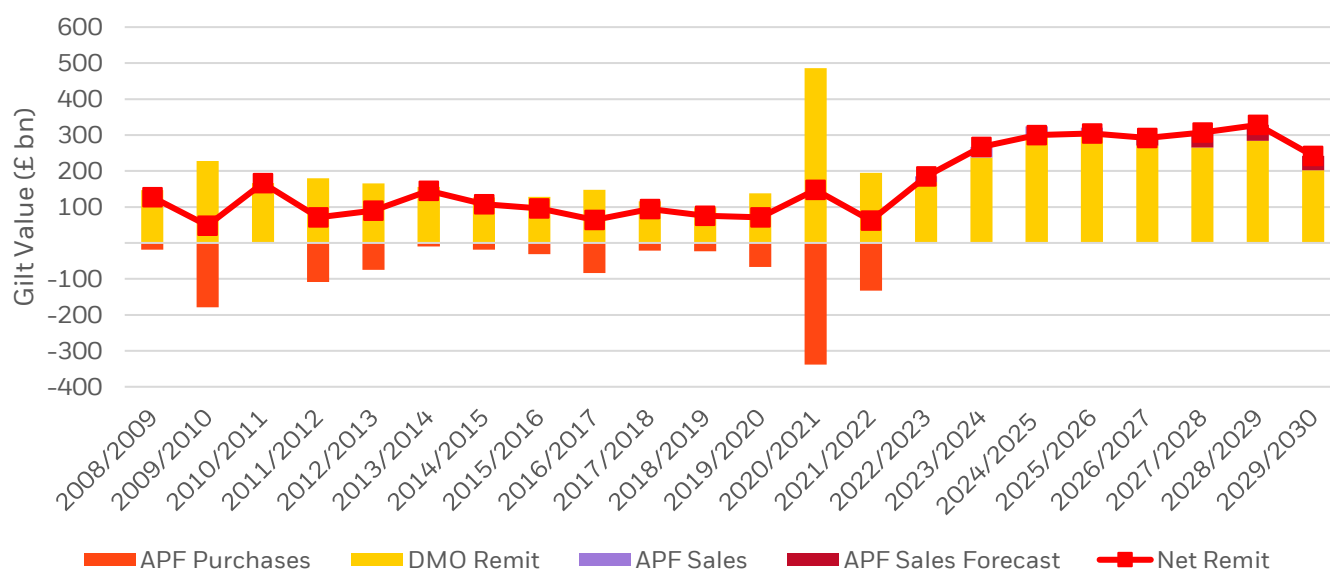
In summary on the fiscal front, the Government has an opportunity to be decisive, rebuild significant head room, help the BoE fight inflation and build market confidence around the credibility of the UK's improving primary deficit position, but navigating the politics of this given manifesto pledges will require bold action.

3) Technical factors: supply is still big, but the composition is shifting in a favourable way

Supply

Over the next five years, gross issuance is expected to remain heavy. For FY 2025-26 alone, the DMO flagged roughly £299bn of gilt sales, with quarterly updates and scope to shift composition as conditions evolve.

Close to passing peak gilt issuance but many years of very large remits to come

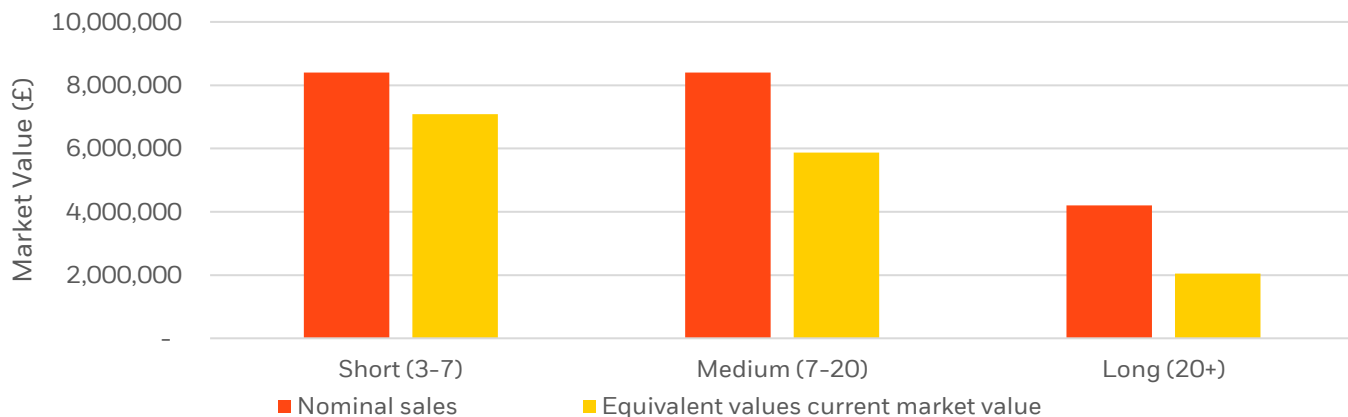


Forecasts may not come to pass. Source: BlackRock, DMO, BoE, ONS. Assume constant rate of APF sales and evolving redemption profile.

Seasonality typically increases pressure into the autumn, but with the cancellation of a long-dated auction and November's index-linked gilt syndication confirmed as a shorter than typical 2038s, the degree of long end supply has materially shifted. A conscious decision taken by the DMO to react to shifting demand dynamics, which has been swiftly and decisively handled.

The BoE is also helping the situation with its decisions on Quantitative Tightening. The MPC has cut the annual QT target of passive roll off and active sales from £100bn to £70bn over the next twelve months and will sell fewer longs, with an indicative 40-40-20 split short, medium, long. The fact that this split is based on purchase price further compounds the skew, with long dated, higher duration bonds having fallen in value by far more than shorter dated bonds, leaving the total long bucket QT sales at just £2bn over the coming year.

Skew in sales leaves limited long dated bond sales from BoE



Source: BlackRock, BoE. Data as at 23 October 2025.

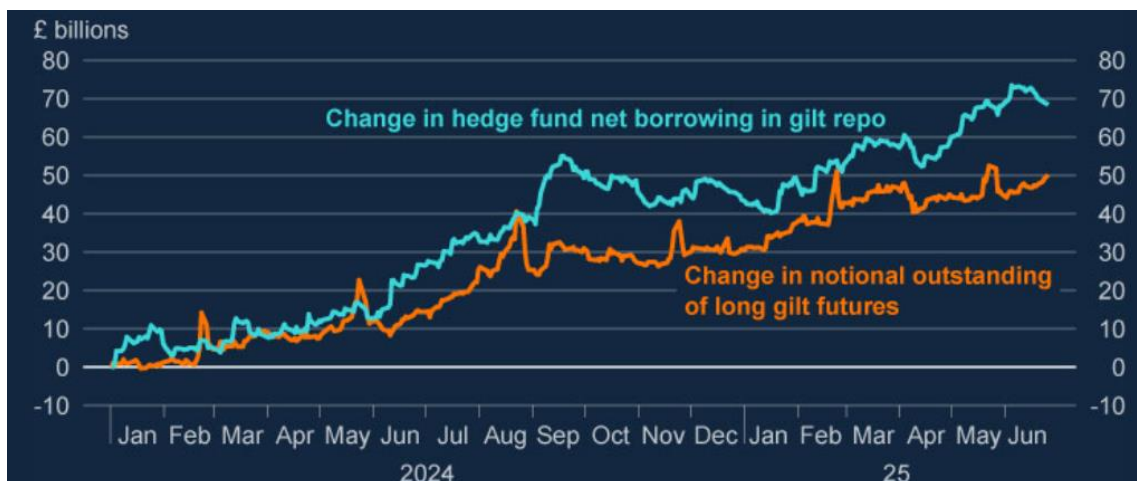
While the total supply of gilts is still significant in monetary terms, the supply of long dated risk coming to the market has been significantly reduced. The term premium that has built into the gilt market over the last few years may persist but these changes may limit further growth in this.

Demand

The buyer base for gilts is evolving. Defined benefit pension schemes are no longer systematic net buyers in the way they have been. Insurers have pivoted toward gilts from credit on a capital-adjusted relative-value basis as Z-spreads widened and credit spreads compressed. As we've written about in previous Views from the LDI desk updates, this has been a significant tailwind for gilts at a time other buyers had stepped back.

Ownership and trading flow data underline the new regime. Overseas and other financial institutions are larger marginal players and hedge funds account for a significant share of gilt trading volumes, which can amplify volatility as positioning turns. Hedge funds in particular have shown signs of significant growth in leveraged gilt positions focussed on shorter tenors.

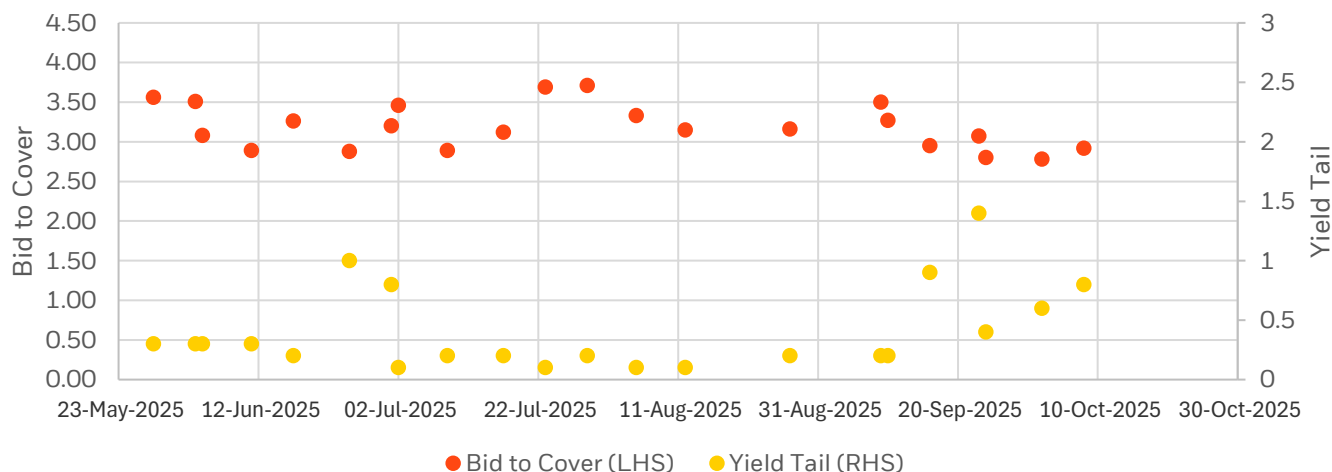
Hedge fund net gilt repo borrowing has grown alongside futures open interest, suggesting growth in cash-futures basis trades



Source: BoE Financial Policy Committee July 2025 Report. [Financial Stability Report - July 2025](#) | Bank of England

While this demand will be welcome to the DMO, signs in recent auctions of increasing yield tails (the difference between the highest accepted yield and the average yield of the winning bids) and falling bid to cover ratios show that market balance remains delicate.

Support for gilt auctions has been waning as we approach the budget



Source: BlackRock, DMO. The *yield tail* in a gilt auction is the difference between the *average accepted yield* and the *lowest accepted yield*. A **large tail** means investors demanded a wider range of yields to buy the debt - weaker demand or uncertainty about fair value. The *bid-to-cover ratio* measures how many pounds were bid for every pound of gilt sold. A lower ratio indicates weaker investor appetite.

But in summary, while still challenging compared to the halcyon days in the mid-2010s when the DMO could sell high volumes of gilts into insatiable pension demand, technicals are in a reasonable balance. Supply skews to shorter tenors and more extreme actions from the DMO to adjust to end investor demand are rebalancing the supply and demand imbalance. Auction outcomes and market liquidity will be something to closely watch heading into the budget itself.

Key Takeaways

- The macro picture remains mixed for gilts, with the UK lagging other regions in the pace and depth of rate cuts as inflation remains sticky, although there are signs the labour market is starting to weaken.
- The fiscal position remains challenging, as it is in many countries, but we think the UK story isn't as bad as it first appears. Reform of the primary deficit is progressing.
- Market technicals (supply and demand) while still challenging relative to overwhelming pension scheme demand of the 2010s, are improving thanks to increased dynamism from the DMO on issuance profile and BoE skewing its' QT sales.
- Post 2022 and the loss of credibility this brought remains a risk, but by rebuilding a larger headroom and targeting policies that reduce inflation, in turn making room for the BoE to cut further and faster, the outlook for gilts can be put on a more positive trajectory.
- It appears this message is starting to resonate in the Treasury and strong gilt market performance over the last couple of weeks supports this narrative.

The opinions expressed are as of November 2025 and are subject to change at any time due to changes in market or economic conditions. The above descriptions are meant to be illustrative. There is no guarantee that any forecasts made will come to pass.

Risks

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

Important information

This material is for distribution to Professional Clients (as defined by the Financial Conduct Authority or MiFID Rules) only and should not be relied upon by any other persons.

Issued by BlackRock Investment Management (UK) Limited, authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Tel: + 44 (0)20 7743 3000. Registered in England and Wales No. 02020394. For your protection telephone calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock.

Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy.

This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock funds and has not been prepared in connection with any such offer.

© 2025 BlackRock, Inc. All Rights reserved. BLACKROCK, BLACKROCK SOLUTIONS, and iSHARES are trademarks of BlackRock, Inc. or its affiliates All other trademarks are those of their respective owners.

BlackRock