

Executive summary

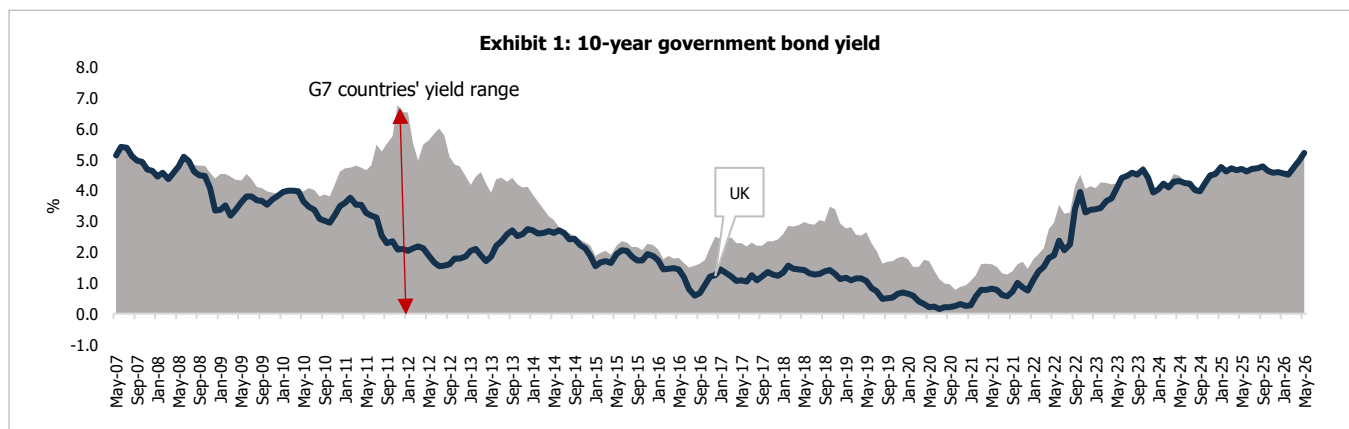
The UK now faces the highest borrowing costs amid the G7 countries following a sharp rise in government bond yields (see Exhibit 1). This spike is driven by three key catalysts:

1. Macroeconomic challenges such as sluggish growth and constrained fiscal space: In 2026, the UK is expected to post low growth rate at 0.8%, high fiscal deficit at 3.1% of GDP, and high debt at 103.1% of GDP.
2. Elevated policy rate: Despite moderating food and energy prices, persistent services inflation and strong wage growth keep the UK's headline inflation above the Bank of England's (BoE) 2% target. Consequently, prolonged high policy rates continue to raise borrowing costs and bond yields.
3. Bond ownership shifts towards price-sensitive investors such as private and overseas participants: The investor base has moved away from traditional, stable holders such as pension funds and insurers towards more price-sensitive and globally-oriented participants. The BoE has transitioned from being a major buyer of bonds to actively reducing its holdings through quantitative tightening. Consequently, the market risk premium has increased.

UK bond yields reflect a new market-driven equilibrium

Higher UK bond yields reflect a new, market-driven equilibrium than a deterioration in macroeconomic fundamentals compared with G7 peers. Notably, the UK's credit profile is supported by the following factors:

- a) It is not an outlier on macroeconomic factors among the G7. Moreover, these factors are projected to improve at a better pace over the next five years, as per IMF WEO projections (see Exhibits 2-4).
- b) The UK benefits from important structural strengths such as reserve currency, global financial centre status, and strong institutions & governance framework.
- c) Market indicators have shown continued investor confidence, with strong demand for gilts and stable market credit risk measures.



Source: Haver Analytics, CareEdge Global

UK is not an outlier among G7; its macroeconomic indicators are improving

According to the IMF WEO, despite growing at 0.8% in 2026, the UK is expected to perform better than Italy, Japan, and Germany. Its growth rate is projected to nearly double over 2027-31 due to higher productivity, while other G7 peers are expected to see limited improvement (see Exhibit 2).

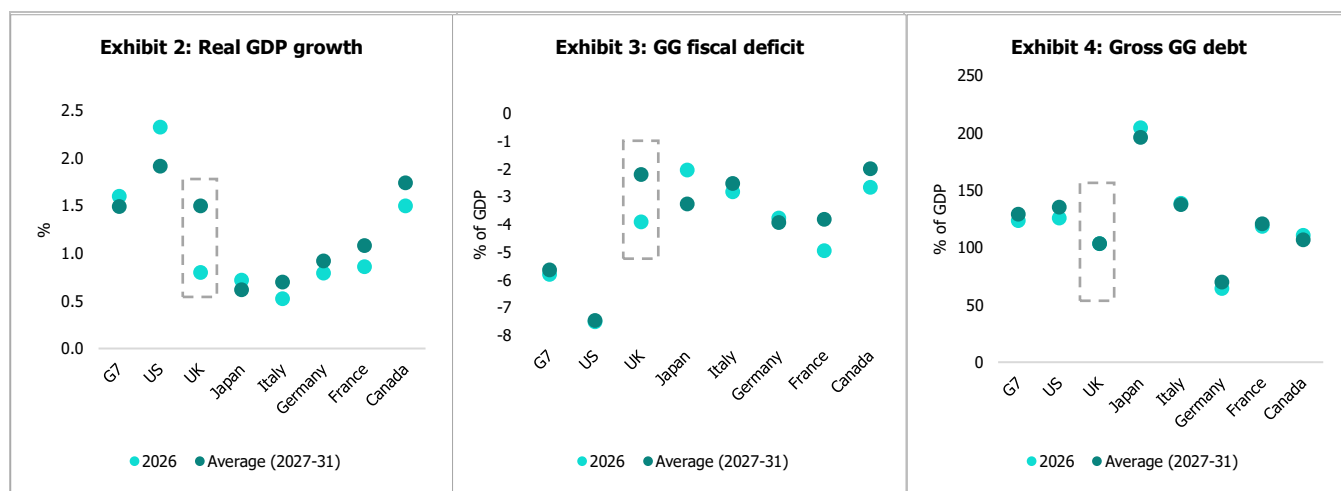
According to the IMF Article IV report, the UK will face increasing spending pressures over the coming years. These pressures could add about 3% of GDP to public spending by 2031. The main reasons are ageing population, rising healthcare and pension costs, higher defence spending, and the need for climate change-related investment.

At the same time, the UK has limited flexibility in its public finances. Taxes are already rising and are expected to reach around 38% of GDP by 2031, which would be one of the highest levels in recent history. Economic growth is also expected to remain modest, averaging 1.4% per year, which will make it difficult to expand the government’s revenue base further.

Despite these fiscal challenges, the UK’s debt ratio will remain the lowest among G7 countries except Germany.

Looking ahead, the UK’s fiscal metrics are expected to improve. Its fiscal deficit (as % of GDP) is expected to narrow significantly, by about 2.3 percentage points (pp), while improvements in G7 economies are likely to be much smaller, by average of 0.3pp (see Exhibit 3). Similarly, the UK’s debt-to-GDP ratio is expected to slightly improve, by about 1pp vs a deterioration of average of 9pp for other countries (see Exhibit 4).

This suggests that fiscal fundamentals alone do not fully explain why UK government bond yields are relatively high and volatile. Instead, there are deeper structural factors at play.



Source: IMF WEO April 2026, CareEdge Global

Structural changes in UK government bond market

While the UK faces rising spending pressures and tight fiscal flexibility, its position is not weakest among G7 peers, as detailed above. To understand why the UK government’s borrowing costs are relatively high, it is helpful to break them into two components: the central bank’s interest rate and the extra return (or premium) that investors demand to hold UK government bonds.

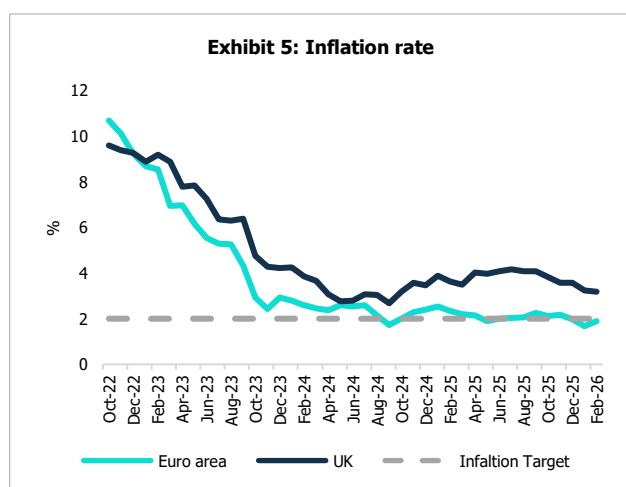
a) Stubborn inflation keeps the BoE cautious and policy rates higher for longer

The UK's headline inflation has remained above the BoE's 2% target since the Russia-Ukraine energy shock. Although energy and food pressures have eased over time, core inflation has stayed higher than in the Euro area. One major reason is the initial energy shock, which hit the UK harder because of its limited gas storage capacity and higher exposure to global energy markets (see Exhibit 5).

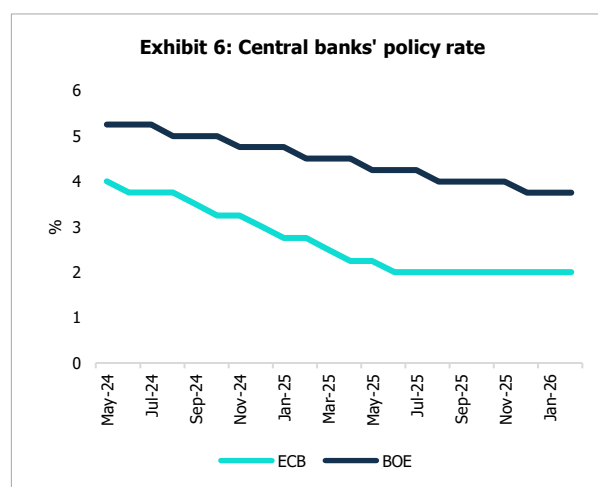
Over time, the drivers of inflation have changed—from external factors such as energy prices to domestic factors. In particular, services inflation, such as rents and labour-intensive sectors, has remained high due to tight labour markets and supply constraints.

Additionally, the increase in “administered” prices—those influenced or partly controlled by the government, such as water bills, public transport fares, and some housing costs—has widened the inflation gap between the UK and the Euro area. These have risen faster in the UK than in peer economies, driving the international divergence.

Persistent inflation has constrained the BoE's capacity to cut interest rates. Consequently, the BoE has cut interest rates more cautiously than the European Central Bank (ECB). This has led to a “higher for longer” interest rate environment. Resultantly, borrowing costs in the gilt market have remained high, as investors price in prolonged high interest rates and demand extra returns for holding UK government bonds (see Exhibit 6).



Source: Haver Analytics, CareEdge Global



Source: Haver Analytics, CareEdge Global

Shift in the marginal buyer: From domestic anchors to price-sensitive global capital

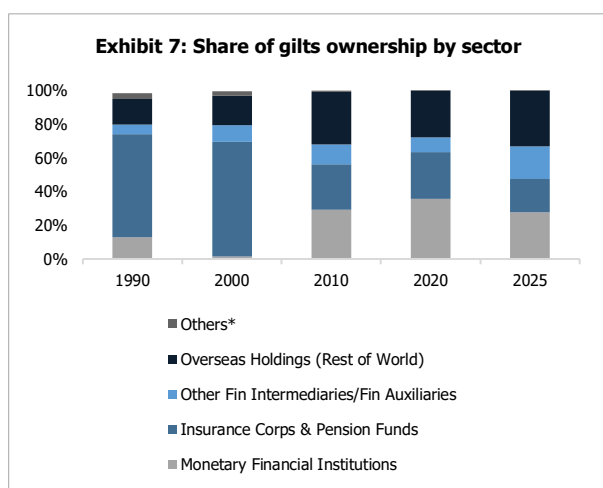
Another major factor for high borrowing cost is the rise in the risk premium that investors demand to hold UK government bonds, highlighting a growing role of private and overseas investors in the gilt market.

The UK government bond market has seen a major change in its investor base along with increase in supply. Historically, demand came from domestic pension funds and insurance companies, which were not very price-sensitive because they mainly bought bonds to match their long-term liabilities. This created a stable source of demand, especially for long-term bonds, and helped keep yields steady.

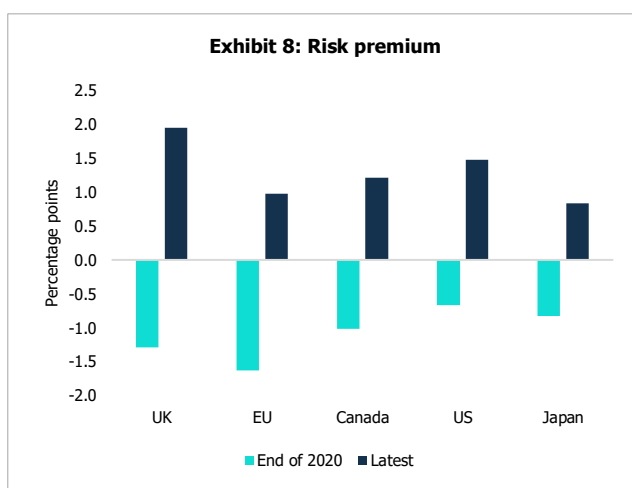
But this has changed over time. First, the demand for gilts from domestic pension funds has reduced with the change in pension scheme from defined benefit to defined contribution. Second, the BoE is no longer a large buyer; it has reduced bond holdings after years of quantitative easing.

Hence, a larger share of demand now originates from overseas and market-based investors. These investors are more sensitive to global conditions such as interest rate differentials, currency movements, and shifting risk sentiment. They can also move their money in and out of markets quickly (see Exhibit 7).

Because of this shift, the gilt market has become more volatile. Investors now require a higher return (risk premium) to hold UK government bonds, which has pushed up borrowing costs. This has happened even though the UK's fiscal fundamentals are expected to improve over time (see Exhibit 8).



Source: Haver Analytics, CareEdge Global
*Others include local government/public non-financial corporations/private non-financial corporations /households, and NPISH. Monetary financial institutions comprise the central bank, deposit-taking corporations except the central bank, and money market funds.



Source: Haver Analytics, CareEdge Global

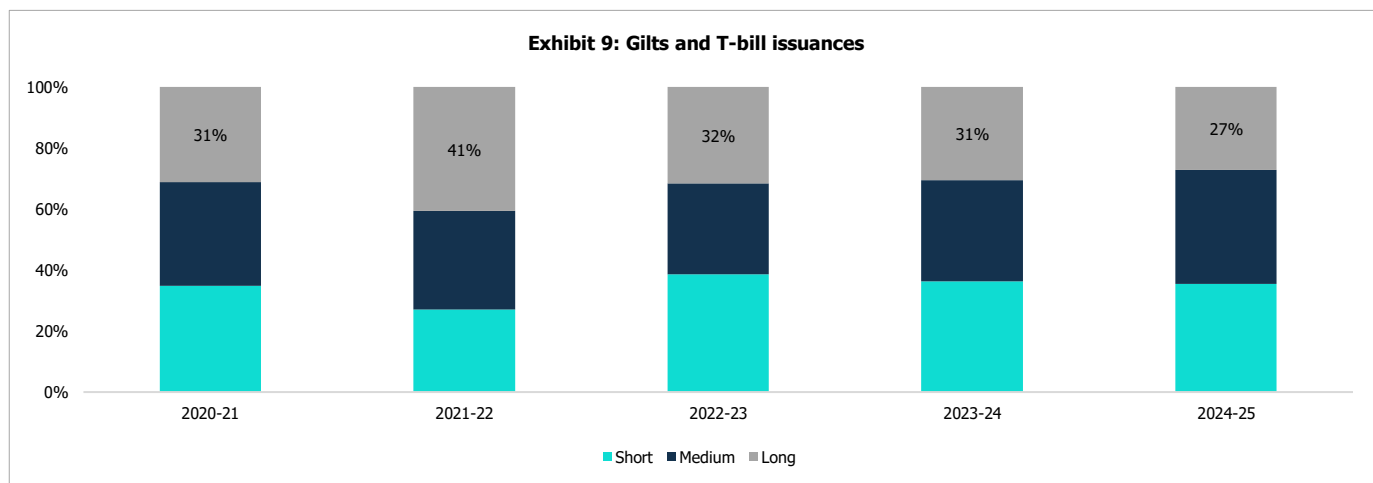
Policy responses focus on reducing market volatility

To reiterate, high UK bond yields are not solely due to fiscal pressures; they are equally driven by expectations of prolonged high interest rates and a higher risk premium demanded by investors. In response, policy actions and signalling have prioritised reinforcing fiscal credibility, managing financing risks, and supporting market stability to enhance investor confidence.

- The government has placed more focus on keeping a financial buffer (“fiscal headroom”) and sticking to its fiscal rules, to reassure investors.
- Policy actions have also aimed at keeping financial markets stable. For instance, the BoE has slowed the pace of its bond sales (quantitative tightening) from about £100bn to £70bn per year (from October 2025). In simple terms, this reduces the amount of government bonds being pushed into the market at once, helping to limit upward pressure on yields.

Shift in government borrowing strategy toward shorter-term bonds

The Debt Management Office (DMO) has changed how it raises funds by issuing relatively more short- and medium-term bonds instead of long-term ones. This reflects weaker demand and higher interest rates on long-term bonds and helps reduce the immediate cost of borrowing (see Exhibit 9).

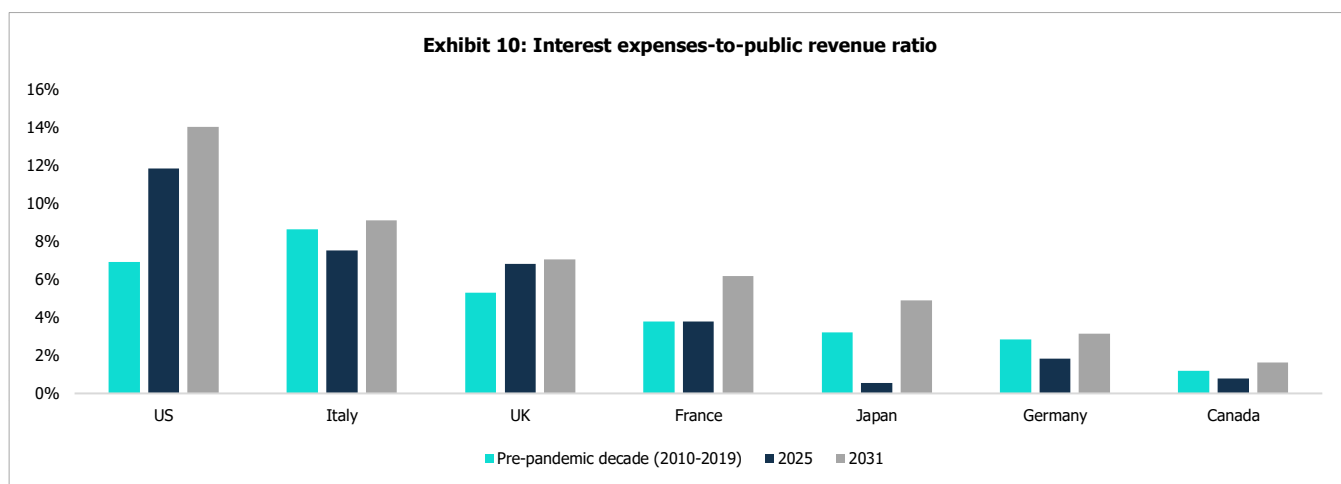


Source: Haver Analytics, CareEdge Global

Note: Short-dated gilts have a residual maturity of between 0 and 7 years, medium-dated gilts have a residual maturity of between 7 and 15 years, and long-dated gilts have a residual maturity of over 15 years.

Interest burden rising more slowly than G7 peers

Debt interest expenses have increased to about 6.8% of government revenue compared with around 5% before the pandemic. However, it is expected to stay stable at about 7% over the next five years, which means the UK is likely to face less pressure than some other G7 countries where these costs are rising faster (see Exhibit 10).



Source: IMF WEO, CareEdge Global

Positive market signals

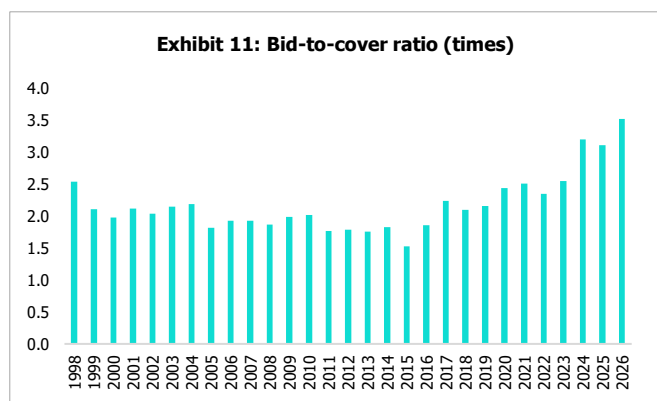
Market indicators show that investor confidence in the UK remains strong, even amid higher yields and volatility. Demand for UK government bonds continues to hold firm, as seen in healthy bid-to-cover ratios at recent auctions (see Exhibit 11).

Structural reset in UK gilts

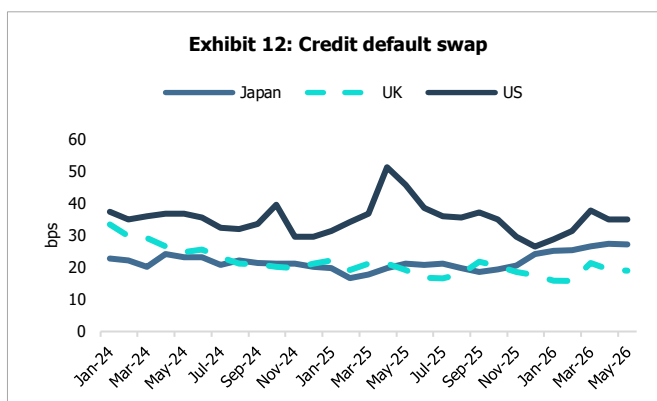
At the same time, credit default swap (CDS) spreads in the UK are lower than those of the US and Japan. In contrast, CDS spreads in the US and Japan have not declined in tandem (see Exhibit 12).

Furthermore, the UK benefits from the strength of the pound as a reserve currency and its position as a global financial centre. It also has strong institutions and governance, as shown by its high governance scores, even though there has been recent political uncertainty.

This suggests that higher bond yields are not seen as a sign of weak confidence, but rather as a normal adjustment to tighter financial conditions, while overall outlook remains stable.



Source: DMO, CareEdge Global
 2026 data is year to date.



Source: Refinitiv, CareEdge Global

Conclusion

The rise in UK government bond yields is driven by macroeconomic pressures, inflation dynamics, and structural shifts in the bond market. Because the UK’s macroeconomic backdrop is broadly aligned with G7 economies, the other two serve as differentiators. Persistent inflation has kept interest rates high, while a pivot towards market-driven investors and reduced central bank support have increased volatility and risk premiums.

At the same time, the UK continues to benefit from strong underlying strengths, including improving fiscal fundamentals, a global investor base, sterling’s reserve currency status, and strong governance frameworks. These pillars suggest that higher yields are largely a reflection of a new, market-driven environment rather than declining investor trust.

Going forward, maintaining fiscal discipline, controlling inflation, and managing market volatility will be key to stabilising borrowing costs and cementing investor confidence.

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