

EUROPEAN ECONOMICS & RATES STRATEGY

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(Geo-) Politics and The Gilt Curve

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All values in EUR and GBP unless otherwise noted.

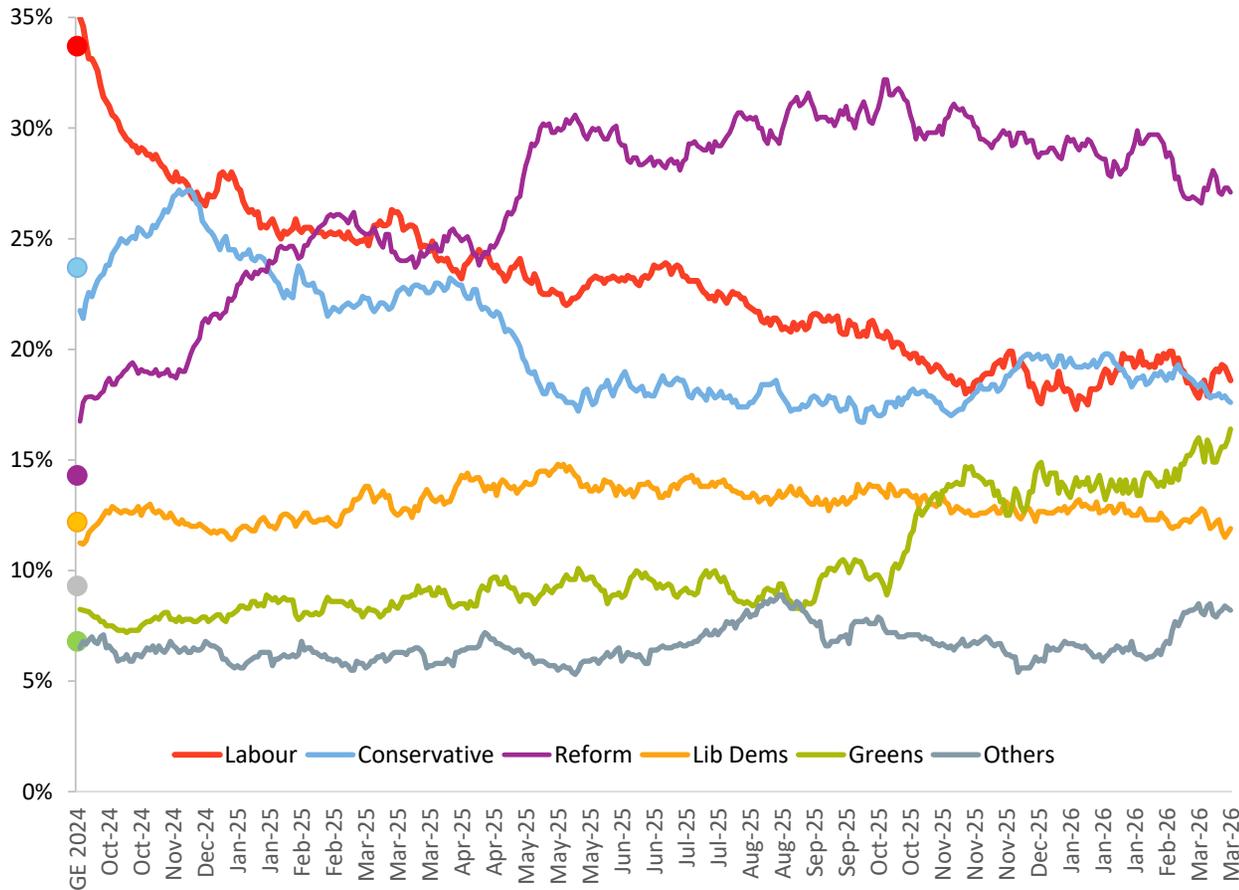
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UK political risk rears its head again

'poll of polls' — UK parliament voting intention (%)



- The **Labour Party** has shed almost half of its support from the July 2024 general election.
- Coming into 2026, **May's local and regional elections** are seen by investors as a key test for the Prime Minister's leadership.



'Churn' has become a defining feature of UK politics over the past decade.

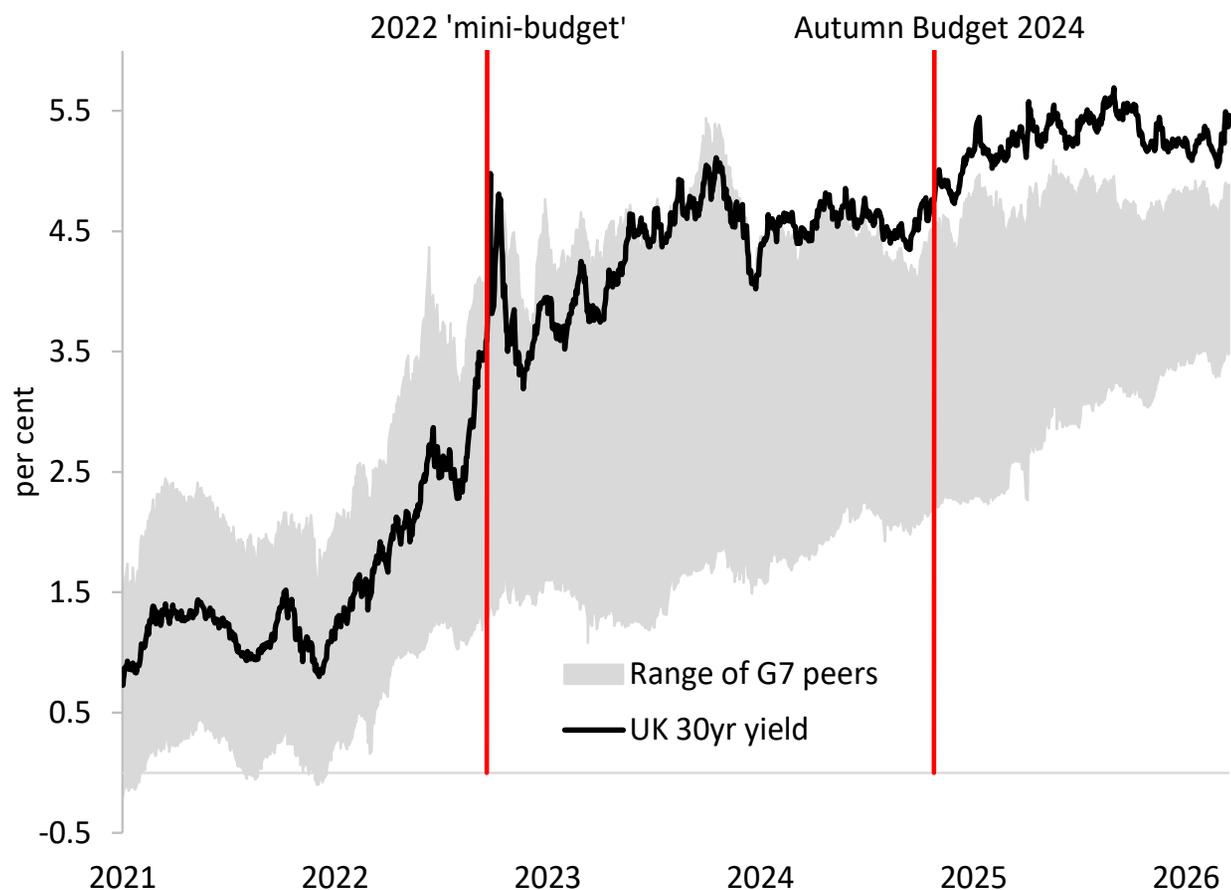
The UK has had five Prime Ministers since July 2016.

By contrast, the five Prime Ministers prior to July 2016 spanned a 37-year period going back to May 1979.

Source: various polling companies; RBC Capital Markets

Domestic 'political risk' is really 'fiscal risk'

UK 30-year Gilt yield vs. G7 peers



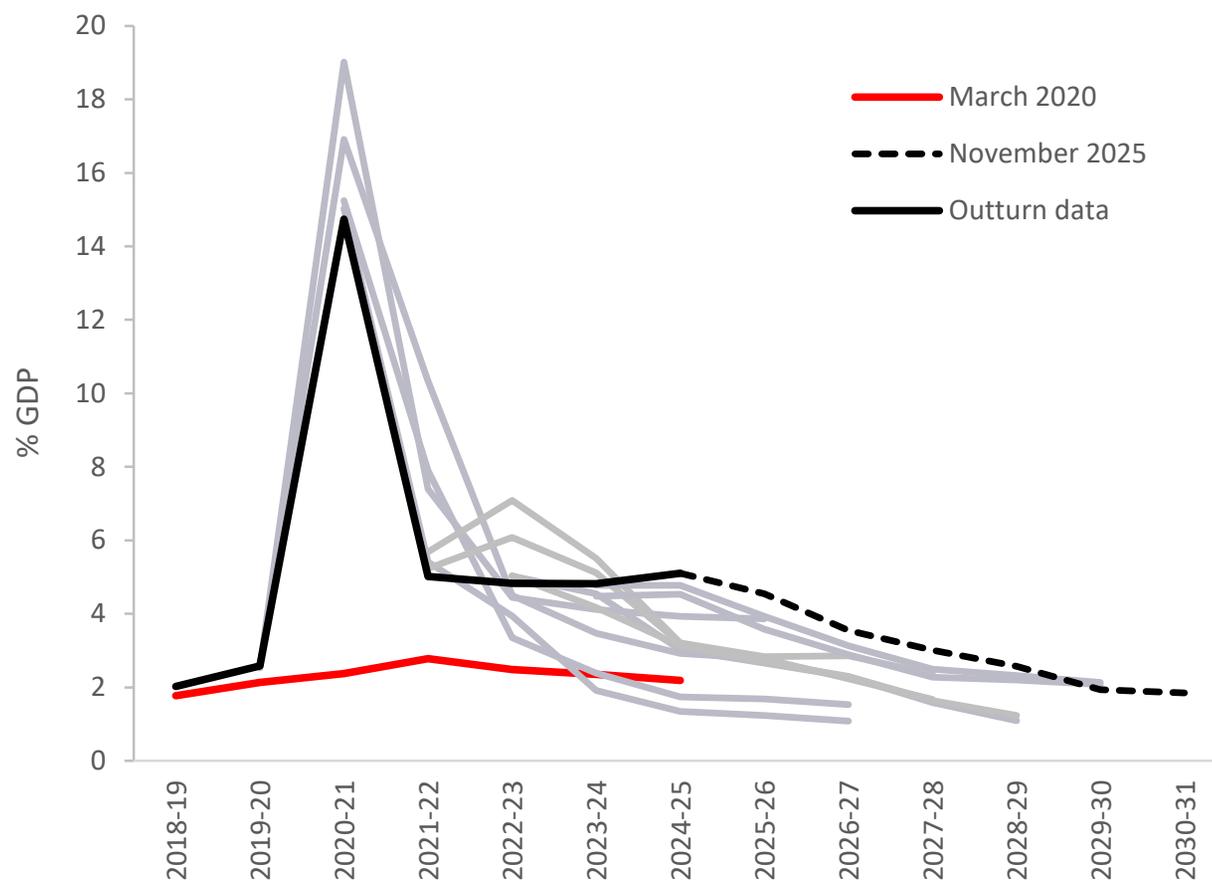
- **'Fiscal risk' concerns have dogged the UK** in recent years — arguably since the 'mini-Budget episode' of Autumn 2022.
- In addition, the **persistence of inflation following the 2022/23 energy price shock** has kept UK front-end rates higher than in advanced economy peers.



The 2025 Budget lifted near-term concerns around the outlook for fiscal policy while the outlook for gilt supply also offered some support to the market.

Post-pandemic forecasts for public finance have proved overoptimistic

Public Sector Net Borrowing (PSNB) as a % GDP — outturn vs. successive OBR forecasts



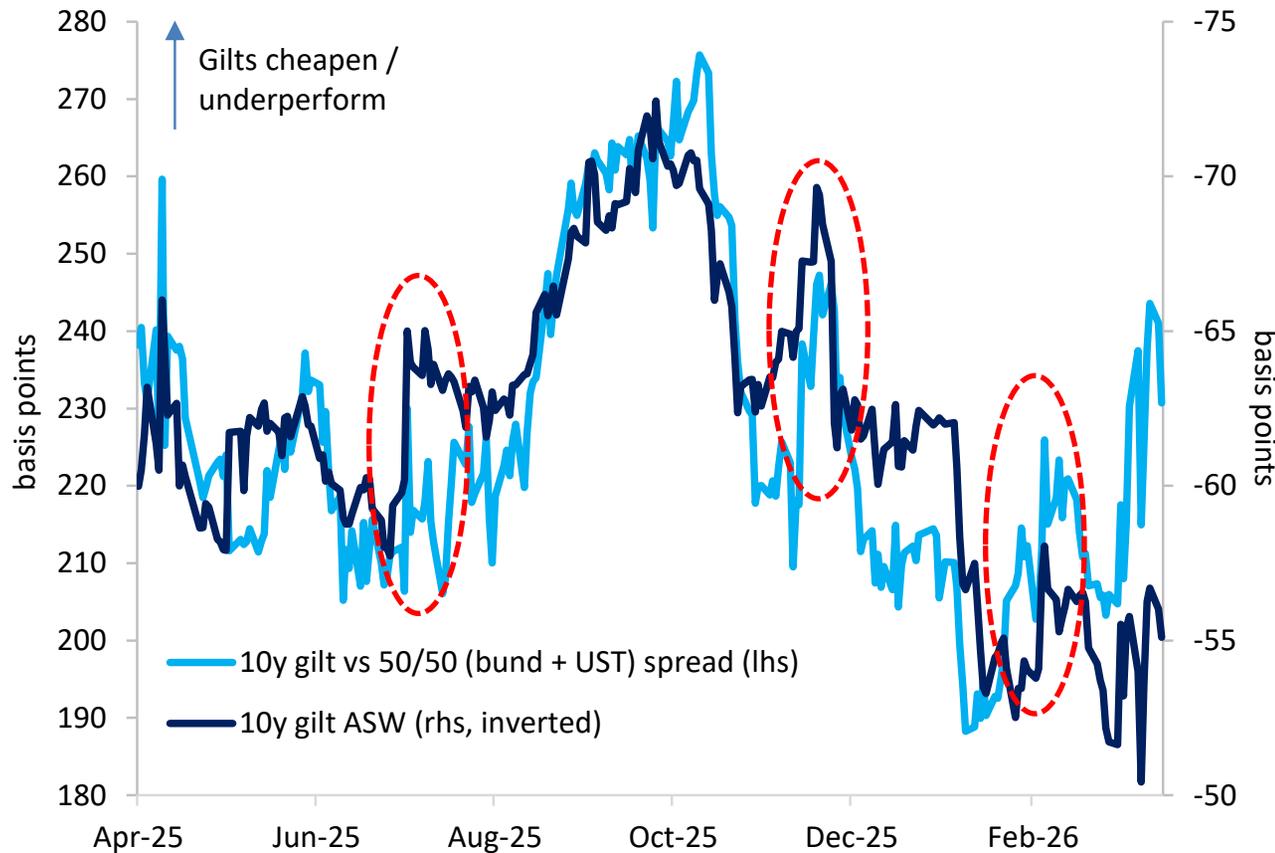
- **The Budget deficit (PSNB)** has held at c. 5% GDP post pandemic and has tended to come in above OBR forecasts.
- In part that reflects **overoptimistic growth forecasts but also policy decisions.**



Despite successive deficit reduction plans, PSNB has been stuck at around 5% GDP for the past four fiscal years. Current plans to meet the current fiscal rules are premised on 'tight' spending plans and large tax increases over the forecast horizon.

Post-pandemic forecasts for public finance have proved overoptimistic

Domestic UK political events are reflected in gilt market moves



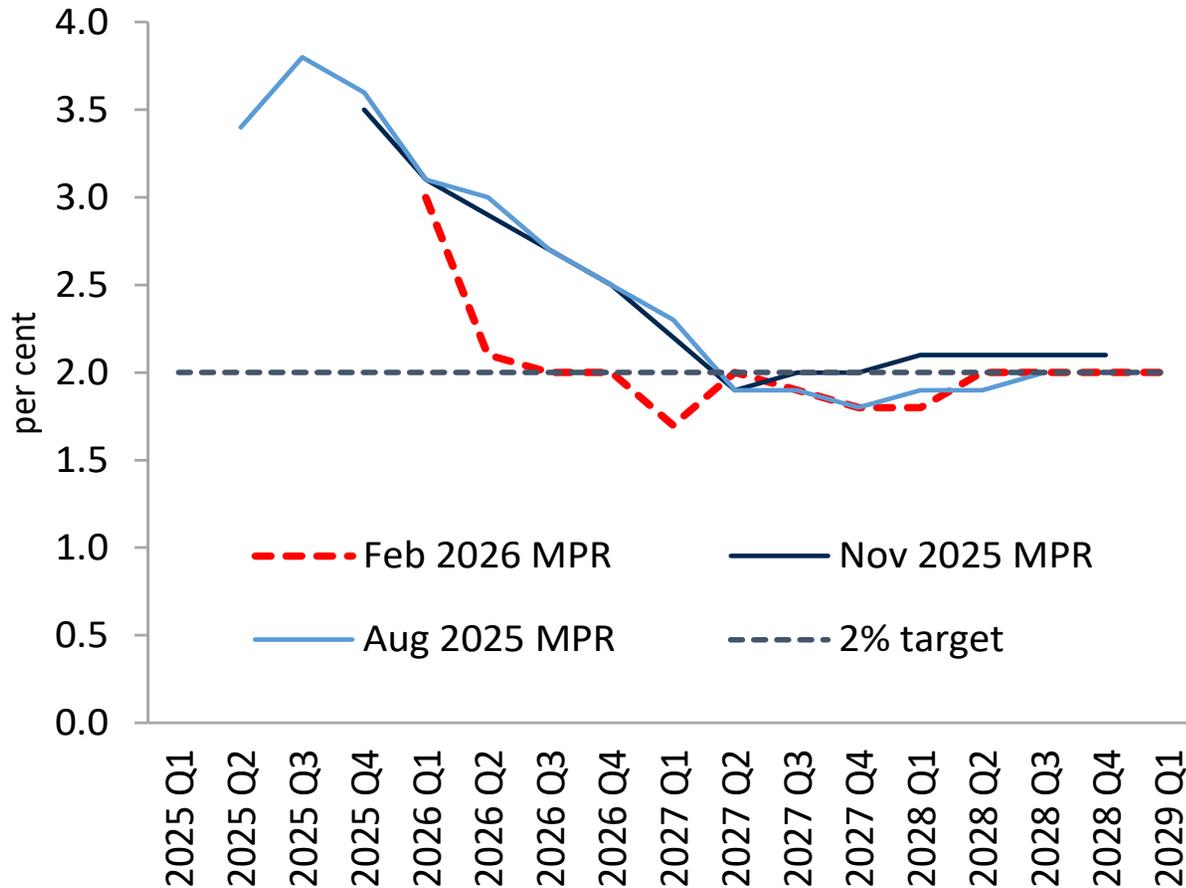
- Markets' default assumption appears to be that a change of Prime Minister would also lead to a change of Chancellor and with it a loosening of fiscal policy.
- In the recent past, the market has reacted to idiosyncratic UK political events.



The market has previously reacted negatively, for example, when it appeared that either the Chancellor or Prime Minister might be about to be replaced.

February MPC saw the BoE give a dovish message on inflation

Monetary Policy Report: central CPI inflation projections (% , y/y)



- The **MPC sounded more confident** on the path of inflation at its February forecast round with forecasts showing CPI inflation returning to target sooner than previously.
- But key to the view that **the risks from inflation persistence had become less pronounced** which stems from developments in the labour market.



Measures announced at Budget 2025 reduce CPI inflation by c.0.5ppts from April onwards. The February MPR forecasts showed CPI inflation seen returning to target toward the end of Q2 2026 and remaining there for the forecast period.

Oil price movements can feed into consumer prices for fuel quickly

Brent crude oil price (\$, bbl) 2019 – present



- Since the outbreak of the conflict, the price of a barrel of oil has risen sharply.
- **Higher oil prices feed quickly into domestic ‘pump’ prices** of petrol and diesel with much of that coming in the first month after the initial rise.
- According to data from the DESNZ, petrol prices are up 13p since the end of February, diesel prices 27p.



**Changes in oil prices feed into pump prices quickly.
As a price point that consumers encounter regularly,
they may also have an immediate impact on inflation expectations.**

Some of the MPC were already concerned about inflation expectations

BoE/Ipsos Inflation Attitudes Survey — median inflation expectations next 12 months



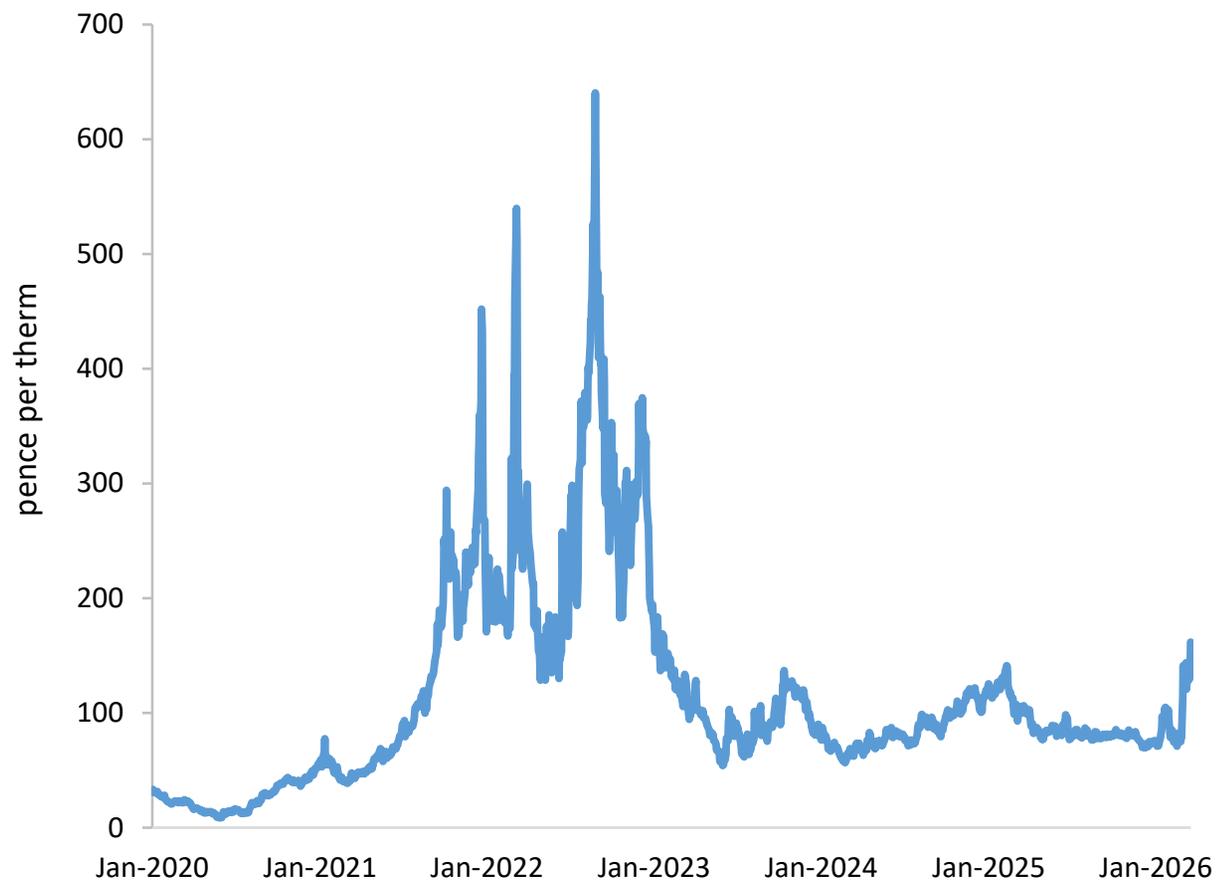
- **Year-ahead household inflation expectations** remain above their long-term averages. Medium-term household measures remain elevated.
- Inflation expectations likely reflect spot inflation, and the expectation of the MPC was that the ‘normalisation’ of CPI inflation in April would also help temper inflation expectations.



Firms and households were expected to revise down their inflation expectations in response to lower realised inflation with knock on impacts on price setting and wage demands.

Gas price spike revives memories of 2022

UK wholesale gas price (GBP per therm)



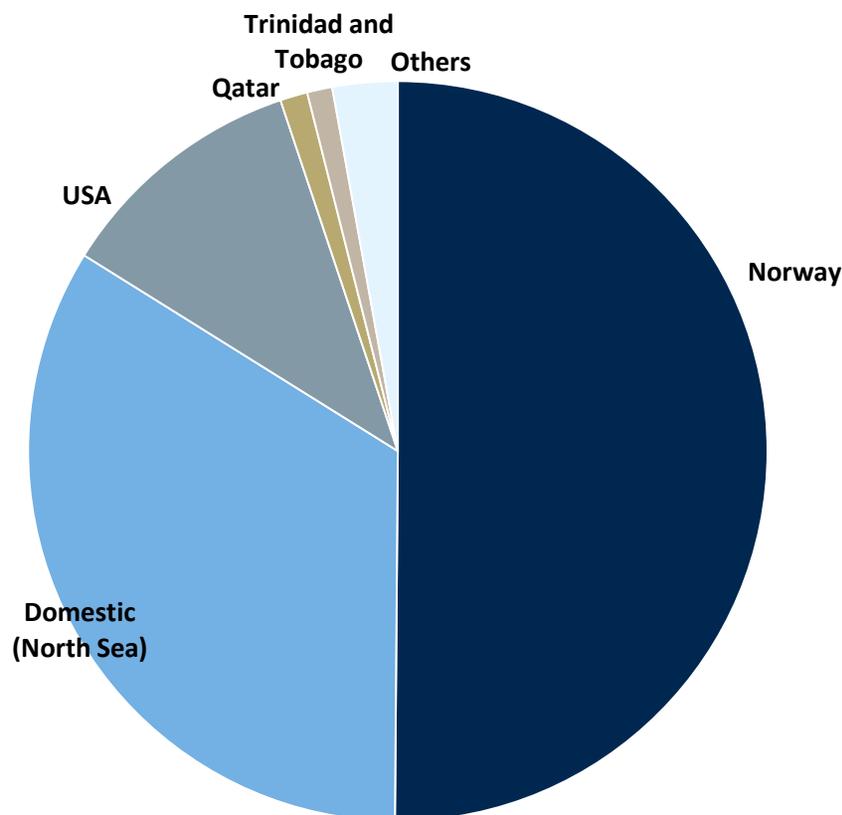
- Since the outbreak of the conflict, **wholesale gas prices are also up sharply** though the move higher in gas is smaller than the magnitude seen in the wake of Russia's invasion of Ukraine.
- The Ofgem price cap slows the impact of gas prices on consumer utilities prices — impact of present gas price developments will be felt from July onwards.



The Ofgem price cap sets prices for three-month pricing periods using wholesale prices over a three-month observation period. The impact on households is delayed but only a short-lived spike in wholesale prices can be diluted under the methodology.

But this is a 'pure' price shock rather than a supply shock

UK's gas sources



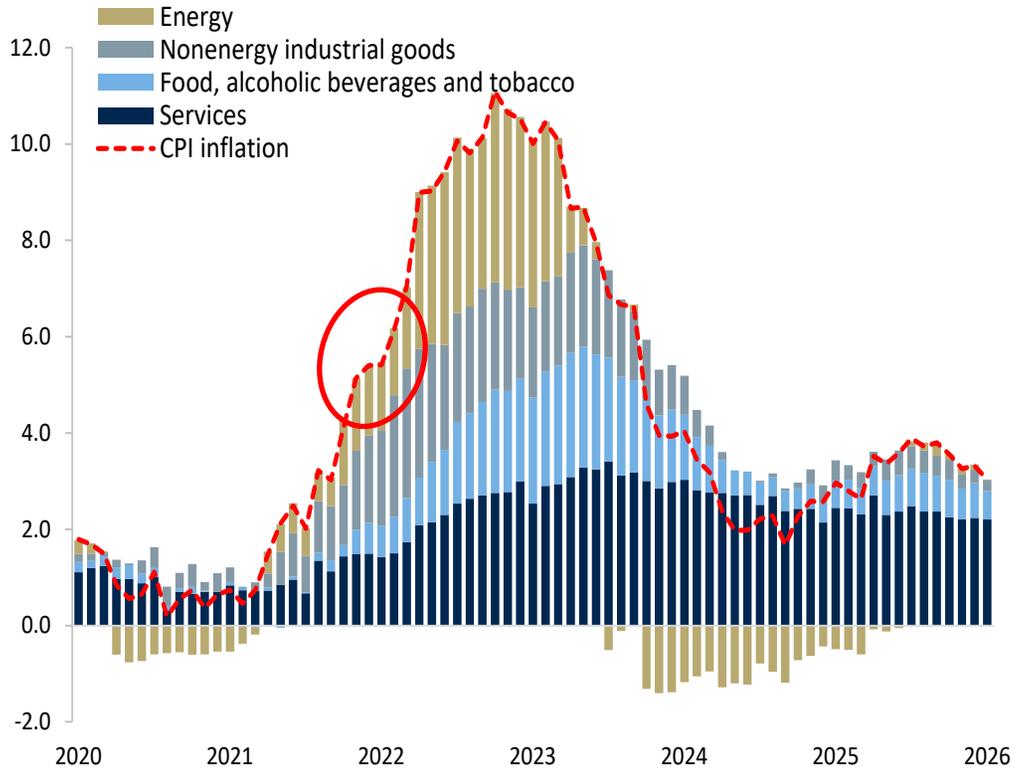
- The 2022 episode was characterized by concerns over supply — at the outbreak of the conflict 60% of EU gas imports came from Russia — European governments had to compete for scarce supply to 'keep the lights on'.
- The UK has only a small direct exposure to the Middle East for gas supplies. In respect of oil, domestic production accounts for c.60% of domestic supply. Around 6.5% of the UK's primary oil imports come from OPEC countries, 15% of total oil and petroleum products.



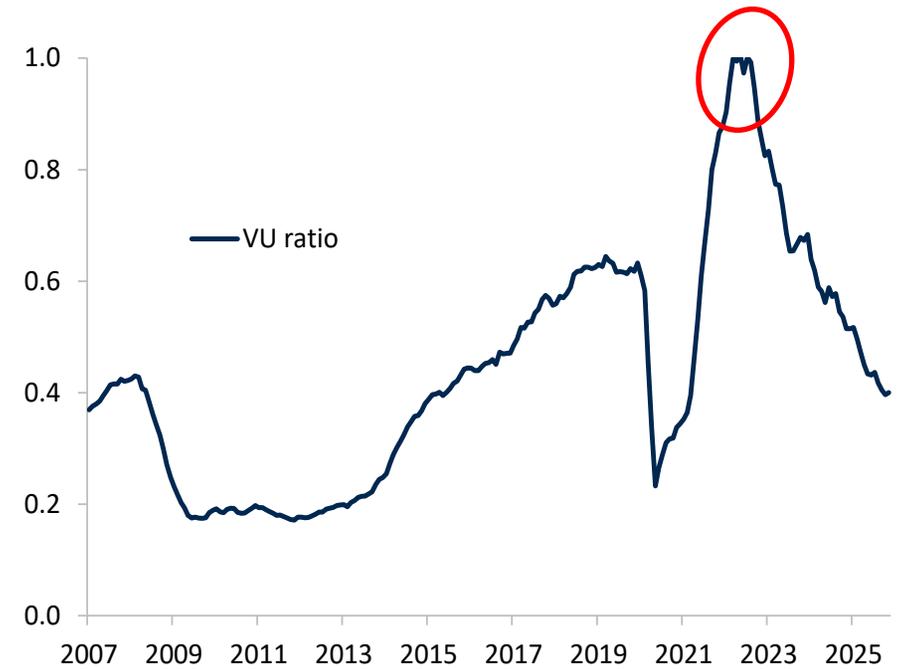
In 2022 the concern was that Europe would run out of physical gas as it 'switched off' Russian supplies. However, while 'pure' supply concerns are less pronounced than in 2022, that doesn't spare Europe from higher energy prices.

Economic backdrop differs from 2022

UK CPI inflation (y/y, %) and ppt contribution by sub-category



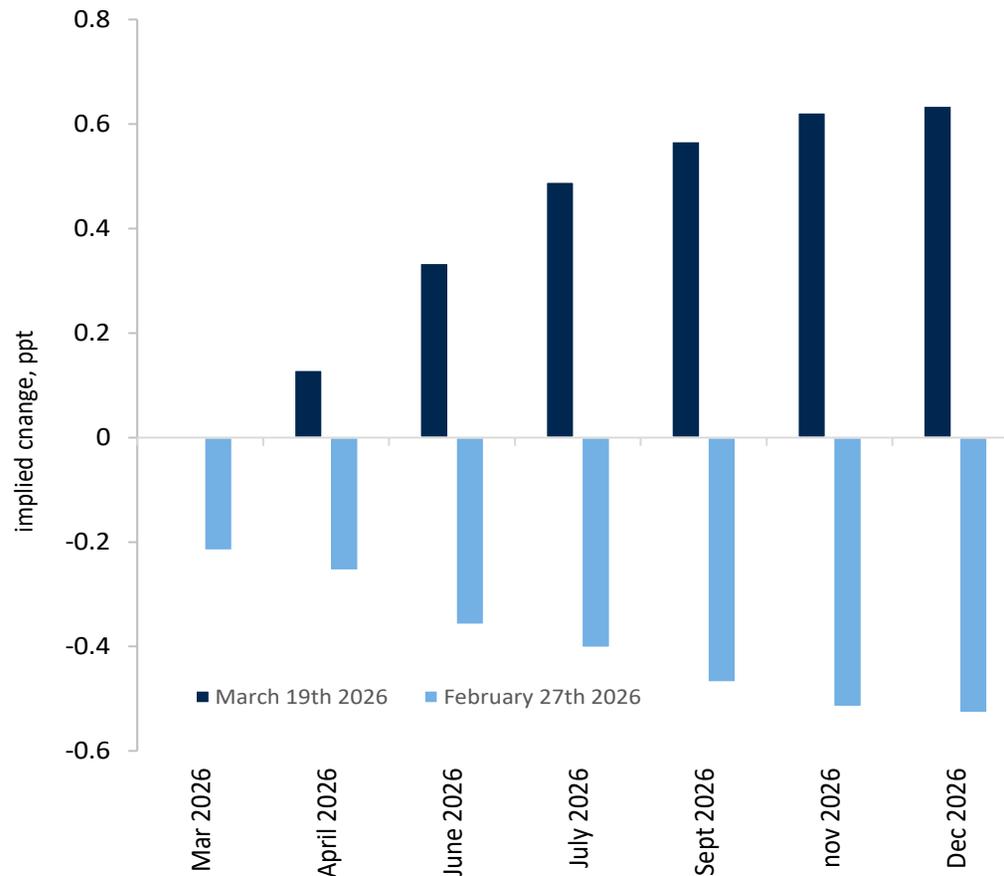
Ratio of vacancies to unemployed (VU ratio) — UK



In Q1 2022, CPI inflation was 6.2% y/y and rising due to post-pandemic supply chain bottlenecks. At the same time, the labour was very tight with economies reopening as restrictions were eased.

Market has priced BoE rate cuts

Implied change in Bank Rate by meeting date (ppts)



- On the eve of the outbreak of hostilities two full MPC cuts were being priced.
- The market view appears to be that Central banks will be reluctant to 'look through' an energy price shock entirely given the experience of 2022.



The spikes in energy prices has seen an abrupt repricing of the front end of the UK and euro area. The market has moved from pricing MPC cuts to pricing hikes while the ECB is no longer seen remaining on hold.

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