Gilts under PRESSURE

20 May 2026

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on MULTIPLE *fronts*

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For those who stayed up to watch Eurovision, the UK's entry once again finished at the bottom of the scoreboard. In many ways, gilts are facing a similar reception from investors. UK government bonds currently appear unloved: the benchmark 10-year gilt is currently trading at a yield last seen nearly two decades ago. This should not come as a surprise, given the range of pressures they face, from global market dynamics to domestic economic challenges and political uncertainty.

Market conditions: a global yield shift

A key driver of gilt weakness is the broader rise in global bond yields. Across G7 markets, sovereign debt is being repriced as investors demand higher compensation for persistent and prospective inflation risks and concerns around fiscal sustainability. The UK is very much part of this trend.

Gilts also face an additional, more idiosyncratic headwind. The Bank of England (BoE) remains engaged in quantitative tightening (QT), where it is actively selling gilts into the market. This contrasts with other major central banks, which have either paused or, in some cases, begun to reverse QT (i.e. in the US), leaving UK gilts more exposed to excess supply and upward pressure on yields.

Economic risks: low growth, high inflation

The UK's macroeconomic backdrop adds further strain. Growth expectations remain subdued relative to peers. Oxford Economics forecasts UK GDP growth of just 0.6% in 2026, compared with 0.8% in the eurozone and 1.9% in the US.[1] Weak growth raises concerns about the sustainability of public finances, particularly as gross debt is almost equivalent to annual GDP. This dynamic leaves the UK especially sensitive to shifts in borrowing costs.

At the same time, inflation risks remain elevated in the UK, reflecting the UK's continued vulnerability as a net energy importer and its historical sensitivity to energy price shocks, which tend to feed more quickly into headline inflation.

The BoE has explicitly highlighted this risk, outlining scenarios in which higher energy prices feed into the broader economy. In its most adverse case, where energy prices remain elevated and second-round effects through wages and inflation expectations take hold, they project inflation could reach as high as 6% by the end of 2026.[2] Should such a scenario materialise, long-dated gilt yields may face further upward pressure.

It is, however, important to recognise that much of this inflation risk has already been reflected in market pricing. Gilt yields have moved significantly higher in recent years, in part to compensate investors for a more persistent and "stickier" inflationary environment. As such, investors are already being compensated for these risks, unless inflation proves materially higher than current expectations.

Political uncertainty

Political risk represents a further layer of uncertainty. Ongoing internal divisions within the Labour Party, alongside speculation around leadership changes, have created an unstable political backdrop.

There is also growing concern about the direction of future fiscal policy. A perceived shift towards looser / expansionary policies, characterised by increased public spending, higher borrowing, and potentially higher taxation, could raise fresh doubts about debt sustainability.

Even the perception of fiscal loosening is enough to unsettle markets, especially at a time when fiscal credibility is already under scrutiny across developed economies.

That said, as with inflation, there is an argument that a degree of fiscal risk is already priced in. Elevated gilt yields and a steeper curve in segments of the market suggest investors are already demanding additional compensation for potential fiscal slippage. In this context, recent fiscal concerns are less a new shock and more an ongoing theme that may persist.

Portfolio strategy: favour short-dated gilts

Taken together, weak growth, higher inflation, debt sustainability concerns, and political uncertainty paint a challenging outlook for gilts.

At the same time, the role of long-dated conventional gilts within portfolios has become less reliable. Historically, they have acted as an effective hedge against equity risk, particularly during demand-led growth shocks. However, recent supply-driven shocks, impacting energy prices, have weakened this relationship, with gilts at times showing a positive correlation with equities. While this shift may not be permanent, it can reduce their diversification benefits, especially in a higher-inflation environment.

Against this backdrop, newly elevated yields may bring improved opportunities for income generation, but we retain a clear preference for shorter maturity rather than longer maturity UK government bonds. Returns from shorter maturities provide greater resilience in the face of uncertainty surrounding government fiscal policy and inflation dynamics.

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Speak to us

Sources

[1] LSEG/Evelyn Partners

[2] Monetary Policy Report, BoE, April 2026

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