

Special Coverage: Rachel Reeves' escape act

Key takeaways

- ◆ Chancellor Reeves faced a difficult escape act as she was caged in by economic headwinds and rising borrowing costs, while adhering to fiscal rules and commitments to not hiking taxes.
- ◆ Amid the competing forces to cut back on spending but maintain growth, Ms. Reeves risks facing the prospect of not meeting the fiscal rules again in October. She is likely reasoning that there is a significantly lower bar to beat for the UK economy, putting less risk of having to make further spending cuts or break her promise to not increase taxes.
- ◆ Gilts were buoyed by softer-than-expected inflation data and lower forecasts of debt issuance. Nothing was announced to deter us from our view that gilts offer an attractive real return amid geopolitical uncertainty and market volatility. We see market expectations as too cautious in the number of rate cuts and expect another six 0.25% cuts between now and Q3 2026. This implies that gilt yields should fall from here and that a balanced portfolio is a strong alternative to falling cash rates.



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What happened?

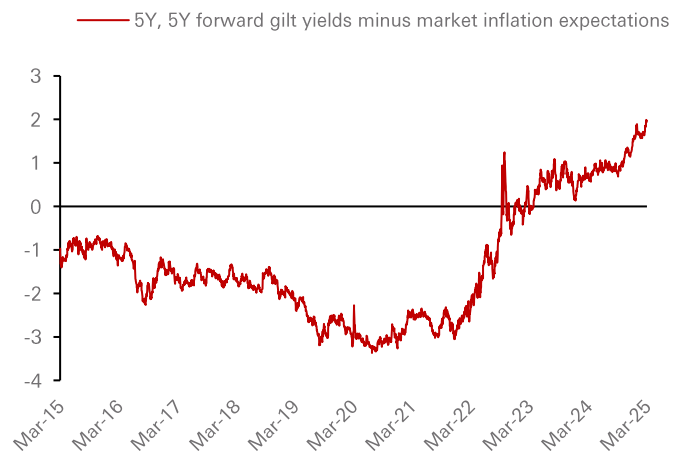
- Economic headwinds, tight fiscal rules and a commitment to not hiking taxes meant that this would be a challenging Spring Statement for Chancellor Reeves. This gave her limited room to manoeuvre.
- Since the October statement, UK economic growth had disappointed, and a downgrade in the GDP forecast from the Office of Budget Responsibility (OBR) was a given. This year's GDP growth forecast was cut in half to 1%. With reduced growth forecasts, Ms. Reeves' spending plans were vulnerable to the fiscal rules that the budget should be on course to be in balance or surplus by 2029/30 ("stability rule"). This meant that cuts were deemed as essential in sticking to the rules and, above all, retaining market confidence.
- With the government's net financial debt-to-GDP at over 80%, keeping the market onside prevents borrowing costs from running away, and risking a negative spiral of higher borrowing costs and therefore even more spending cuts. The real pinch point for Ms. Reeves was the rule that the net debt-to-GDP, which had to be falling within a "five-year time frame" ("investment rule"), had a wafer-thin margin of error. She took a scalpel to welfare spending, saving £3.4bn after extra spending is included, so that the forecasted headroom to this rule was maintained at £9.9bn.
- Ms. Reeves also committed to cutting government running costs to the tune of £2bn by the end of the decade, while cutting down on tax fraud net another £1bn. As expected, foreign aid was also cut, tying that saving to the increase in defence spending to 2.5% of GDP.

- The OBR is baking in a sizable pick-up in house building, accelerating to over 305,000 houses being built annually by 2028/29. They now forecast GDP to grow 1.9% in 2026, 1.8% in 2027, 1.7% in 2028, and 1.8% in 2029. This helped keep Ms. Reeves within that very tight fiscal rule to shrink the government debt pile.
- The Chancellor also had room for a modest surprise aimed at her priority of boosting growth, with a £2bn commitment to export finance.
- Headline CPI inflation fell more than expected in February to 2.8% y-o-y. That said, there remains a stickiness to services inflation. This means that the Bank of England (BoE) is likely to take a cautious path lower.
- The knock to inflation and lowering of growth expectations bolstered market expectations of rate cuts. The market now sees rates falling another 0.50% by the end of the year. We think that the BoE is keener to cut more than the market anticipates. Inflation should peak in late summer before turning lower, while the labour market is weaker than it looks in volatile headline numbers. We expect the BoE to cut rates once per quarter to get to 3% by Q3 2026.

Investment implications

- Amid a volatile backdrop of geopolitical uncertainty and imminent tariff risk following the US administration's review of reciprocal tariffs, gilts offer an attractive inflation-adjusted yield, even if our more dovish view on rates doesn't transpire.
- Banking a 2% "real" inflation adjusted yield is a great way of diversifying away from risk while also avoiding diminishing cash rates. All factors solidify our bullish views on UK gilts.
- Consumer sentiment is still off the pre-October budget peak and isn't yet showing signs of recovery. This will be the key indicator to watch in the coming months and will form a critical part of our tactical positioning in the UK equity markets.
- Broadly, we think that most risks are now priced in until there is more clarity on further tariffs and the impact of the last couple of months' uncertainty on business behaviour. So, we take a more balanced approach and remain neutral on UK equities.
- For UK investors, the recent strength in GBP has opened a window to buy into a global portfolio at a knocked-down price, especially as US equities are discounted around 10% from their recent highs.

Long-run real rates for gilts are attractive



Source: Bloomberg, HSBC Global Private Banking and Wealth as of 26 March 2025. Past performance is not a reliable indicator of future performance.

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