Deutsche Bank
Chief Investment Office

PERSPECTIVES

Special

January 2025

UK assets: a bumpy start to 2025

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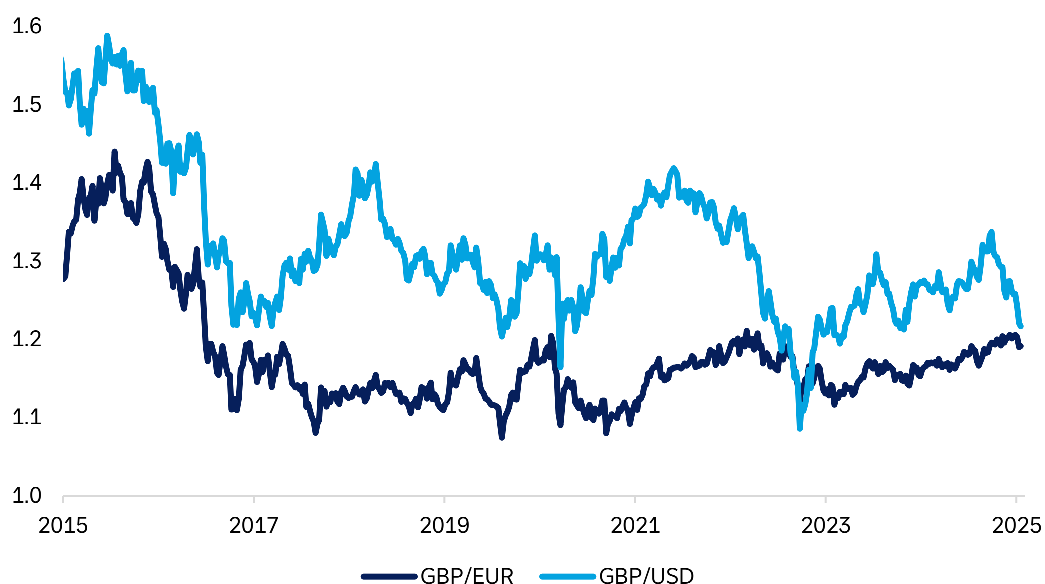
01 Introduction

In brief: Global bond markets off to a rough awakening in 2025, and one of the hardest hit countries is the UK. The fear: market participants worry about a repeat of the 2022 mini budget crisis. The reality: long-term Gilts have been selling off along with U.S. Treasuries. However, short-term risks remain high, inflation data is still important, as well as will be events across the Atlantic around Inauguration Day in the U.S. and the first weeks of Trump administration. We see attractive GBP yields in the medium term with significant carry for UK bonds - both government and IG corporates, and cable (GBP/USD) to stabilise around current levels over the next months.

The dominant theme in markets so far this year has clearly been the upward revision of interest rate expectations, which has spread from the U.S. market to bond trading elsewhere. One of the hardest hit countries is the UK, where assets have come under considerable pressure. For example, since the start of the year, the 10-year and the 30-year gilt yield have each risen 32 bps to nearly 4.9% and 5.5% (as of January 15), their highest levels since 2008 and 1998 respectively. Sterling, the worst performing of the G10 currencies last week, also came under pressure and weakened by -3.6% against the U.S. dollar to GBP/USD 1.2559 between January 7 to January 13, its lowest close since November 2023. Sterling has not fared much better against the euro, depreciating from EUR/GBP 0.8287 to 0.8437 (-1.8%) since the middle of last week.

Figure 1: Sterling over the last decade



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02

Policy drivers

This brings back memories of the “gilt crisis” in autumn 2022, when bond vigilantes took a shot at UK government bonds, believing that the draft budget of the Prime Minister, Liz Truss, and her Chancellor of the Exchequer (i.e. Minister of Finance) was insufficiently funded. The 2022 gilts crash was however – and this is the key difference with the current situation – a British phenomenon. At present, as noted above, yield moves in the UK are embedded in a global upward correction in interest rate expectations, originating in the U.S. dollar as the global reserve currency. In fact, at just under nine basis points, the yield differential between 10-year Gilts and 10-year U.S. Treasuries is currently roughly where it was six months ago, moving more or less sideways. During the 2022 crisis, this spread widened to as much as 60 basis points.

The joint fall in the prices of government bonds and sterling is primarily a reflection of concerns about Britain’s “twin deficit” (i.e. its simultaneous budget and current account deficit). This is the second largest in the G7 nations after the U.S., making Britain particularly dependent on foreign investors to finance it. Unsurprisingly, according to the Office for Budget Responsibility (OBR), international investors held GBP635bn of gilts in Q2 2024, representing more than 30% of all UK government bonds issued – well above the 18% average for advanced economies.

This is a difficult combination to manage, requiring either a reduction in government spending or an increase in taxation in order to maintain the targeted fiscal consolidation. In addition, the fiscal buffer in Chancellor Reeves's last Autumn Budget was only GBP9bn and some analysts believe that this has now been used up following the recent significant rise in capital market interest rates. This makes achieving the announced consolidation of public finances less likely and also makes the planned additional borrowing of some GBP300bn for the current fiscal year – and possibly beyond – significantly more expensive.

Figure 2: UK spreads and recent policy events

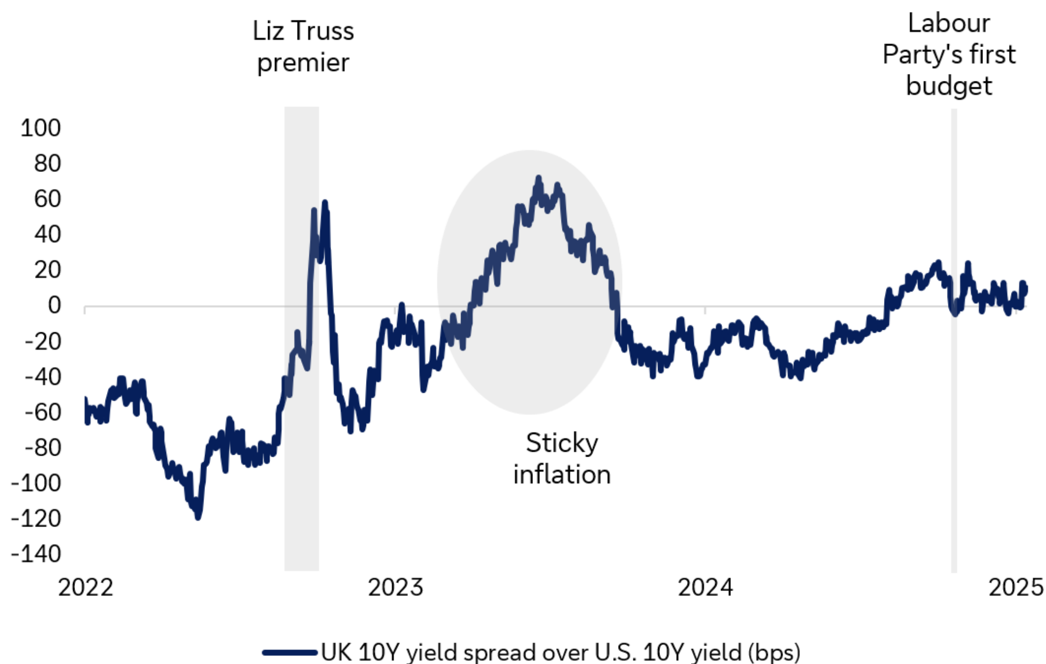

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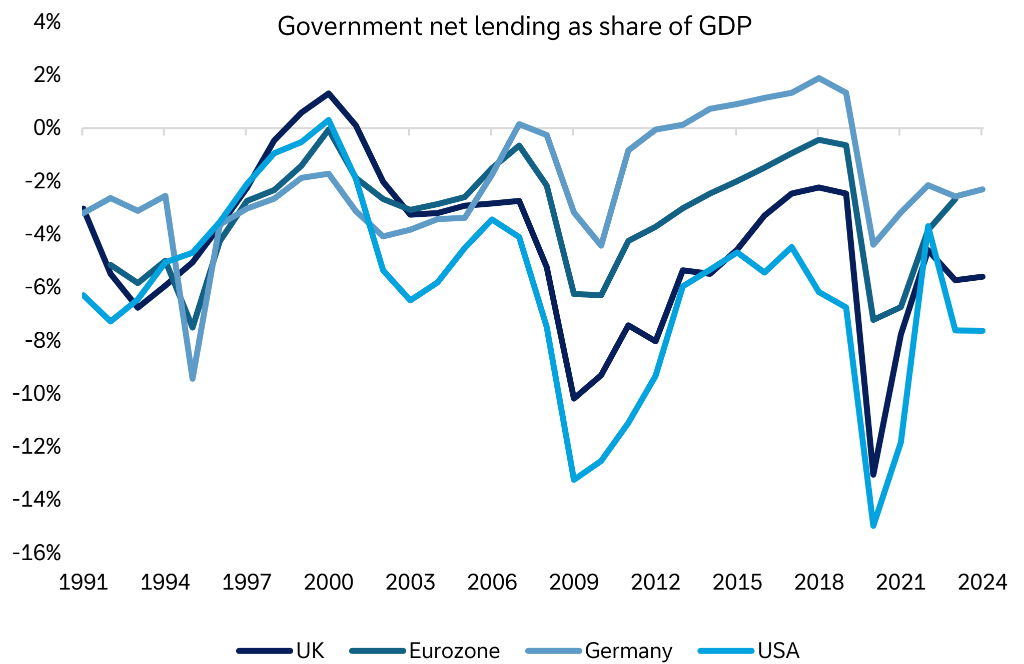
Figure 3: Deficit spending – austerity largely absent



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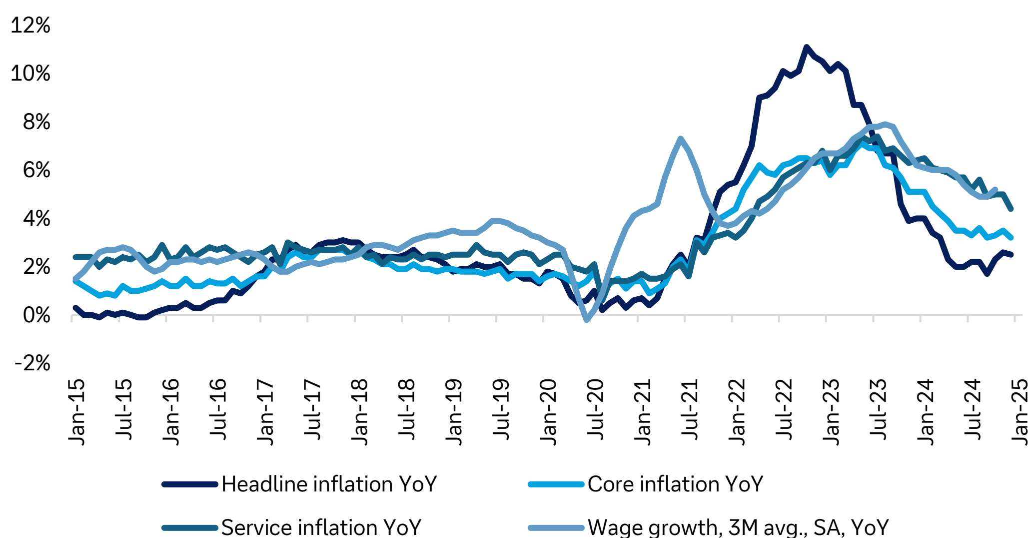
03 Interest rates

The Bank of England is therefore in a challenging position, clearly not wanting to drive further easing too early or too fast, but also trying to avoid cutting rates too late. At least the inflation data released yesterday is cause for cautious optimism. The YoY rate of consumer price inflation fell to 2.5% YoY in December, while most analysts had expected it to remain at 2.6%. CPI rose 0.3% MoM, also below expectations of 0.4% MoM. Underlying inflation trends were similar. The annual core inflation rate fell from 3.5% to 3.2% YoY, while the monthly core inflation rate of 0.3% MoM was below the median expectation of 0.5% MoM. In addition to the slow convergence of the headline and core rates towards the BoE's 2% target, the sharper decline in services inflation from 5.0% YoY in November to 4.4% YoY in December is also encouraging.

After the release of the inflation data, market participants adjusted their expectations for a further 25bps rate cut for the next BoE meeting on February 5. The implicitly priced-in probability via OIS rose from 64% on Tuesday to 86% (or 21 bps) on Wednesday and up to 90% (or 23 bps) today after lower-than-expected November GDP data (see below). By the end of 2025 markets now anticipate cumulative cuts of 59 bps (vs. expectations of 28 bps on Tuesday), i.e. almost two and a half instead of just one rate cut of 25 bps each, which would take the policy rate to 4.16% from the current 4.75%. While at current stage we do anticipate a faster easing path (in particular during H2 2025), it is important to note the non-linearity of any target convergence over time. In particular, the UK follows the broader bond market moves, so active duration management clearly remains key.

As inflation uncertainty may keep investors sceptical about the BoE's ability to cut rates much further (at least in the near future), we expect growth concerns to take centre-stage – especially in H2 2025. The OBR's GDP growth forecast for this year is 2.0%, based on an H2 2024 growth estimate of 0.75%. However, with interest rate expectations higher now higher than in autumn 2024, when the OBR forecast was made, and labour market developments looking more subdued than the OBR's expectation of almost no rise in the unemployment rate over its forecast horizon, economic activity in the last six months of last year is likely to have been broadly flat. Monthly GDP data published today revealed a MoM increase of 0.1% in November, following a -0.1% contraction in October, but below median analysts' expectation of +0.2%. There remains the potential risk of a stagflation scenario and we would not be surprised to see the BoE shift to a more growth supportive tone by the end of late spring, making a faster easing path more likely than markets are currently pricing in.

Figure 4: Inflation reduction: not quite the final mile



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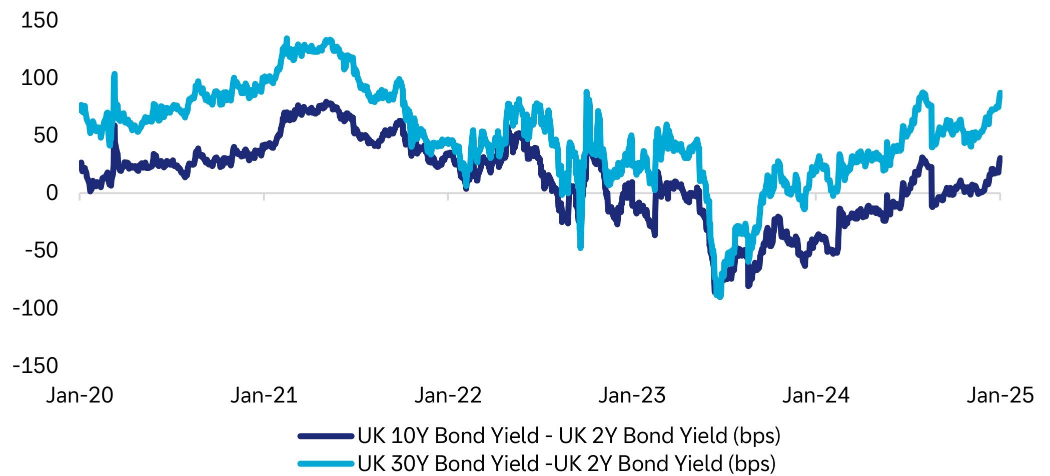
04 Sterling and UK bonds

Sterling could remain under pressure in the short term if further rises in U.S. Treasury yields trigger additional unwinding of long GBP and Gilt positions by foreign investors, who have increased their net Gilt positions by around GBP124bn over the course of 2024 (GBP55bn in October alone). However, potential short-term volatility aside, we see cable (the GBP/USD exchange rate) stabilising around current levels during the next months and the key short-term market driver in the UK (and elsewhere) is likely to remain dynamics in US Treasuries. Here we would not be surprised to see a continuation of recent trends – at least until Inauguration Day on January 20 and President Trump's first weeks in office.

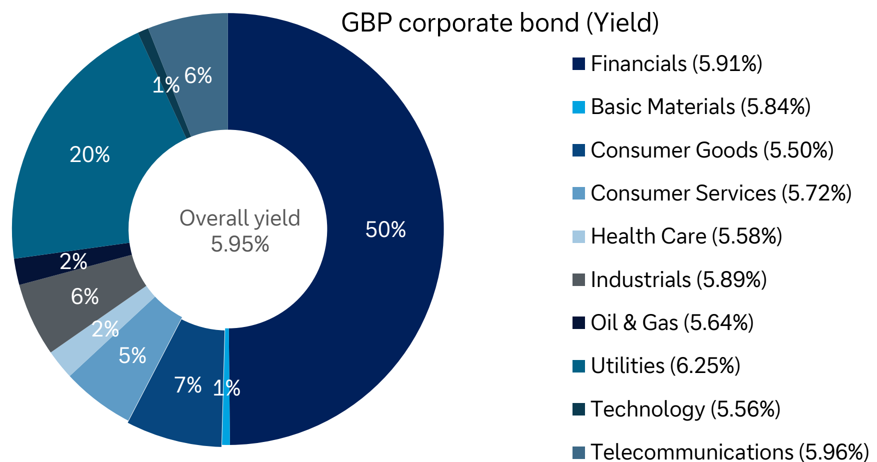
Our end-2025 U.S. Treasury 10-year yield forecast of 4.5% but we do not rule out significant overshooting potential, with UK assets potentially suffering disproportionate volatility due to the perceived vulnerability mentioned above. However, with yield spreads to the U.S. still relatively stable so far, we do not see this as a UK-driven problem per se. Moreover, with 10-year and 30-year gilt yields at multi-decade highs and UK IG yields averaging close to 6%, we see attractive carry in both UK government and corporate bonds.

Figure 5: The curve: back to "normal" without a recession



Source: LSEG Datastream, Deutsche Bank AG. Data as of January 13, 2025.

Figure 6: Well-diversified UK IG market, financials dominate



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05

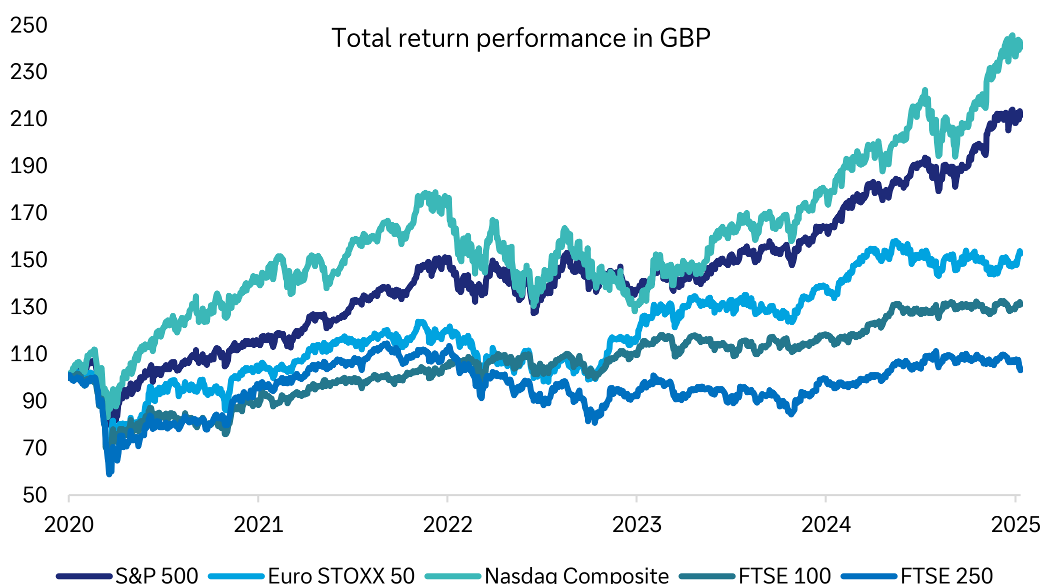
UK equities

Turning to UK equities, recent weakness has been concentrated in the interest-rate sensitive and domestically exposed mid-caps. As of January 14, the mid-cap FTSE 250 index is down -4.1% YTD, in contrast to the large-cap FTSE 100 which is up 0.4%, helped by the fact that its listed companies only generate around a quarter of their revenues domestically. With a similar but less pronounced pattern seen in European and US equities, i.e. SMIDs underperforming large caps, this reinforces the notion that while the accelerated moves in the UK in recent days are country-specific, the broader rotations at play in bond yield-sensitive stocks are more driven by global and in particular U.S. moves.

More fundamentally, the UK's Autumn Budget measures may continue to weigh on the earnings of domestically exposed companies: early corporate commentary suggests that the rising minimum wage and the forthcoming increase in National Insurance contributions will be a challenge for companies with high domestic exposure to the UK and high labour intensity. The BoE's recent survey of over 2,000 UK companies found that 61% expected profits to fall, 54% planned to increase prices and 53% expected to reduce employment as a result of the planned increase in National Insurance contributions (NICs). In addition, sentiment in the UK manufacturing sector fell in December, confirming the fastest rate of contraction in UK manufacturing activity for 11 months.

While the recent corrections in UK equities have helped to bring valuations down towards a possible near-term trough, with the FTSE 100 trading at 11.3x, or 13% below its 10-year average, and the FTSE 250 at 10.7x (25% below its 10-year average), a material recovery seems unlikely in the short term. Market participants may first need to see a reduction in uncertainty – both globally, notably around the policies of the Trump administration once in office, which may influence the direction of global yields, and locally, on the economic data front and in terms of any guidance or commentary from the UK Treasury.

Figure 7: UK stocks: underperforming along with other value markets



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Glossary

The **Bank of England (BoE)** is the UK central bank.

The **consumer price index (CPI)** measures the price of a basket of products and services that is based on the typical consumption of a private household.

EUR is the currency code for the euro, the currency of the Eurozone.

The **EuroStoxx 50** Index tracks the performance of blue-chip stocks in the Eurozone and includes the super-sector leaders in terms of market capitalization.

The **FTSE 100** Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

The **FTSE 250** Index includes the 1st to 350th largest companies on the London Stock Exchange.

The **G7** comprises Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

GBP is the currency code for the British pound/sterling.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Gilts are bonds that are issued by the British Government.

An **investment grade (IG)** rating by a rating agency such as Standard & Poor's indicates that a bond is seen as having a relatively low risk of default.

The **NASDAQ** index is a market-capitalization weighted index of around 3,000 equities listed on the Nasdaq exchange.

The **Office for Budget Responsibility (OBR)** is the UK's official independent budget watchdog.

An **Overnight Index Swap (OIS)** involves swapping an overnight rate for a fixed rate.

The **S&P 500** Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

SMID refers to small and medium cap.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

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Appendix

Historical performance

Performance	13.1.2020 - 13.1.2021	13.1.2021 - 13.1.2022	13.1.2022 - 13.1.2023	13.1.2023 - 13.1.2024	13.1.2024 - 13.1.2025
S&P 500	18.0%	24.0%	-12.7%	21.6%	23.7%
Nasdaq Composite	42.8%	13.5%	-24.5%	36.3%	28.4%
Eurostoxx 50	-1.7%	22.4%	-0.6%	11.5%	14.2%
FTSE 100	-8.6%	16.2%	7.6%	1.1%	11.9%
FTSE250	-3.2%	13.6%	-10.6%	-0.4%	6.0%
UK 2yr Bond Yield	0.8%	-0.9%	-4.0%	2.9%	2.9%
UK 10yr Bond Yield	4.9%	-6.0%	-17.1%	1.6%	-3.5%
UK 30yr Bond Yield	9.1%	-5.9%	-39.2%	-5.0%	-13.3%
IBOXX GBP Corporate Bond Index	6.6%	-2.9%	-15.0%	4.5%	2.2%
EUR vs. GBP	-3.8%	6.7%	-5.6%	3.1%	2.3%
GBP vs. USD	-4.8%	-0.5%	12.1%	-4.1%	4.5%

Source: Deutsche Bank AG, Bloomberg Finance L.P., LSEG Datastream; Data as of January 15, 2025.

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Publication date: January 16, 2025

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