TwentyFour
a boutique of Vontobel

Flash Fixed Income

May 2026

The UK political crisis premium

Key takeaways

- UK government bond yields have surged as investors price in a growing political risk premium, fearing a change of prime minister could loosen fiscal discipline and drive heavier bond issuance.
- This isn't just politics: thin fiscal headroom, heavy issuance, a shrinking domestic buyer base and more hedge fund participation have all made the Gilt market more sensitive to shocks.
- For fixed income investors, we think the repricing of Gilts is a duration and risk premium story, not a corporate credit story. Sovereign stress driven by political uncertainty and supply dynamics does not automatically translate into deteriorating credit quality for UK issuers.

UK government bond yields have pushed higher this month as markets have digested a building political crisis, with the prime minister, Sir Keir Starmer, now set to face a Labour Party leadership contest following dire local election results on May 7.

With 10-year Gilt yields having recently hit their highest level since the global financial crisis, and 30-year Gilt yields their highest level in nearly 30 years, it is worth examining the context which has left the market so vulnerable to shocks.

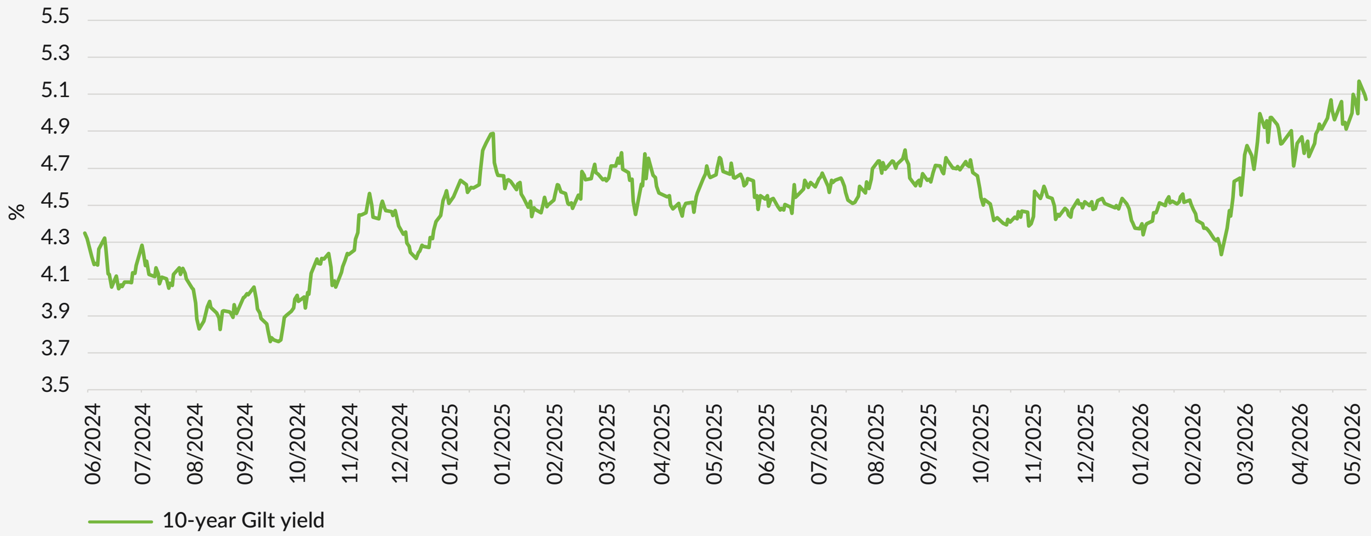
What is happening in the UK?

For several months now, Gilt yields have been sensitive to recurring news flow indicating Starmer could be forced out of office.

Until recently the general pattern was one of spikes in Gilt yields followed by a partial recovery when expectations of an imminent resignation faded, but that trend has been broken by the disastrous local election results of May 7. Buoyed both by the signal that the electorate desires change and the knowledge that these results can be labelled Starmer's responsibility, leadership contenders have now openly stepped forwards. A week is a long time in politics, but at the time of writing there is a strong consensus that Starmer will be out of a job this summer.

Investors have reacted negatively to these developments, with 30-year Gilts hitting 5.82% on May 15, their highest yield since 1998, and 10-year Gilts (see Exhibit 1) hitting 5.17% on the same day, their highest yield since 2008.

Exhibit 1: UK 10-year yields have climbed above 5%



Source: Bloomberg, 18 May 2026.

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	-0.30	-0.82	3.7	4.4
GBP IG	-1.77	-1.59	5.8	5.6
US IG	-0.75	-1.67	5.3	6.4
EUR HY	0.53	0.19	5.5	2.9
GBP HY	0.89	-0.43	8.9	2.9
US HY	0.55	-0.89	7.3	3.2
EM HY	1.55	1.23	7.4	3.9
Euro Senior Banks	-0.13	-0.68	3.5	3.6
COCO	1.41	0.86	6.0	3.6

Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg,

Gordon Shannon
Partner, Co-Head of Investment Grade, industry experience since 2007.

George Curtis
Partner, Portfolio Management, industry experience since 2012.

Investors fret over fiscal rules and Gilt supply

While many would evidently relish a new prime minister, the Gilt market apparently does not. The market's working assumption is that Starmer's replacement will be more left-leaning and come with a more aggressive approach to government spending and therefore borrowing, implying more government bond issuance and a potential further repricing of Gilts.

The market's preferred candidate, Wes Streeting, who represents broadly the status quo in terms of economic management, does not appear to be popular enough with Labour Party members who ultimately vote on a leadership contest. Andy Burnham, the current frontrunner (prediction markets currently place him at around 50%), offers a platform of re-industrialisation, public control of previously privatised industries and council (public) house building. While Burnham recently publicly committed to the government's fiscal rules, investors still point to comments made last year that the government had to "get beyond this thing of being in hock to the bond markets" and they assume that Gilt issuance will be expanded to finance these interventions.

The situation is not helped by the fact that the leadership replacement process is a lengthy and messy one. Burnham is the Mayor of Manchester, but he is not a sitting Member of Parliament (MP). To be eligible for the contest, he first needs to win a by-election being called in Makerfield in mid-June, after the sitting Labour MP stood down to allow him a path to parliament. Victory there is not assured, with Labour's 45% vote share from the 2024 general election looking vulnerable to the rising force of Reform UK. A pre-poll forecast from Survation[1] suggested Reform UK would win the seat comfortably, with 53% of the vote against 27% for a Labour candidate other than Burnham. With Burnham the candidate, the forecast suggests only a narrow win for Labour with 45% of the vote compared to Reform UK's 42%.

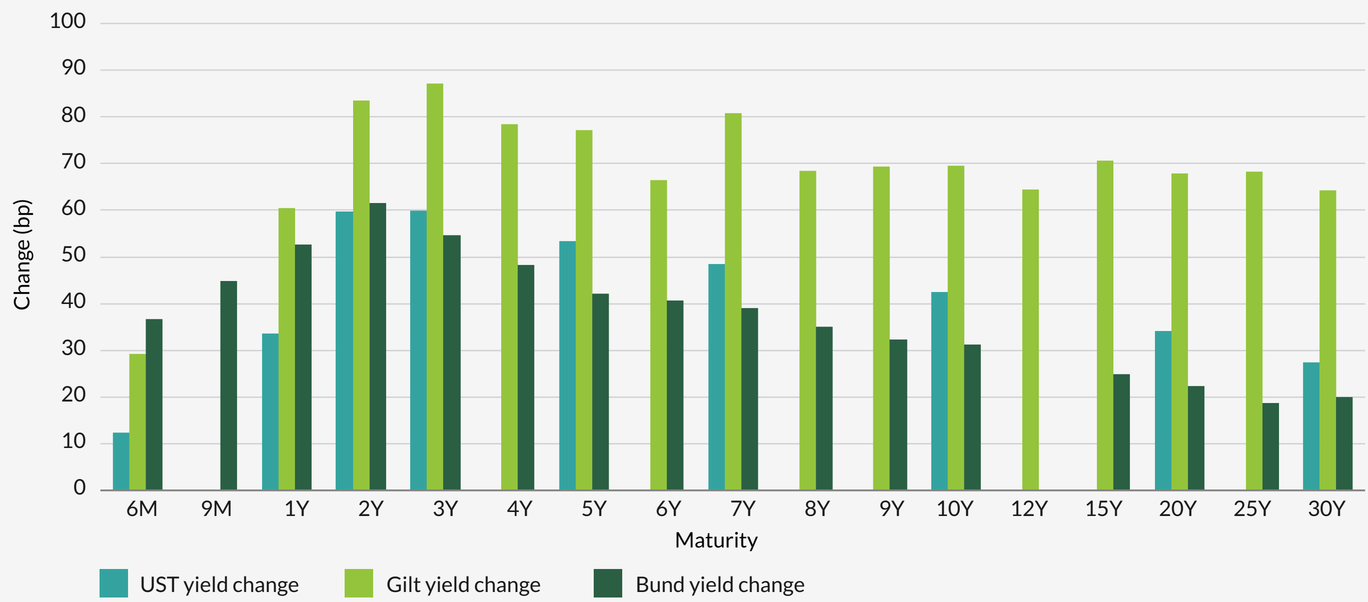
The Gilt market therefore should account for other potential leaders, and a leftward shift does not depend upon Burnham. Former deputy prime minister Angela Rayner, the most likely alternative, is viewed as representing higher spending, more redistribution and a stronger focus on workers' and tenants' rights. Ed Miliband, a former party leader, has signalled a clear climate and net zero agenda tied to increased spending on renewable energy and green industrial policies.

Gilts have decoupled from peers

This has all occurred with the backdrop of the Middle East conflict's impact on the oil price. Higher inflation expectations worldwide have pivoted central bank policy expectations and forced up government bond yields globally, as Exhibit 2 shows.

However, Gilts have markedly underperformed other developed market government bonds year-to-date, even when compared specifically to other energy importing regions like Europe.

Exhibit 2: Gilts have underperformed USTs and Bunds



Source: Bloomberg, 18 May 2026.

1. https://cdn.survation.com/wp-content/uploads/2026/05/15164649/Makerfield_Initial_Estimate_Note.pdf

Rates dashboard

		Current %	Change (bp) 1w	1m	YTD
US Treasury	2yr	4.12	13	40	67
	10yr	4.67	20	42	54
	30yr	5.18	16	30	37
UK Gilt	2yr	4.51	-3	32	78
	10yr	5.13	3	30	63
	30yr	5.80	3	23	57
German Bund	2yr	2.76	4	30	64
	10yr	3.19	9	21	34
	30yr	3.70	8	16	22

	Market projection	Current %	Change (bp) 1w	1m	YTD
Base rate 3.75%	end-2026	3.92	12	38	83
	end-2027	4.01	23	68	79
Base rate 3.75%	end-2026	4.39	-3	34	105
	end-2027	2.87	8	34	50
Base rate 2.00%	end-2026	2.83	-1	29	73
	end-2027	2.87	8	34	50

Indicative market indices, data as at 18 May 2026. Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour.

Why have Gilts become more volatile?

While these political machinations are interesting to track and clearly have real implications for Gilt issuance, in previous cycles UK political turmoil might have created a short period of volatility before the market moved on.

The Gilt market did not experience weeks of instability as the Conservatives changed prime ministers from David Cameron to Theresa May in 2016, for example, and again to Boris Johnson in 2019.

Why have Gilts appeared more sensitive to shocks than other developed market bonds over the last two years? Is the recent underperformance purely political uncertainty?

The first part of that sensitivity is a lack of fiscal headroom. The UK government's fiscal rules are designed to reassure investors that debt will be contained and current spending will not be permanently funded by borrowing. The Office for Budget Responsibility's (OBR) role is crucial in this framework, because the government does not get to mark its own homework. It must submit tax, spending and growth plans to an independent institution whose forecasts determine whether the rules are being met.

At its last forecast in November 2025, the OBR gave the government a 59% probability of achieving a current budget surplus (meeting the fiscal rule) by 2029/30, hardly an overwhelming margin of safety.

That probability matters because a fiscal rule that is met only narrowly is more vulnerable to shocks. Higher inflation can raise welfare spending, departmental budgets and index-linked debt costs. Weaker growth reduces tax receipts. These pressures also interact with each other. Higher Gilt yields increase debt interest costs. A rise in yields worsens the fiscal arithmetic, which reduces headroom, which makes investors more nervous about future borrowing, which can push yields higher again.

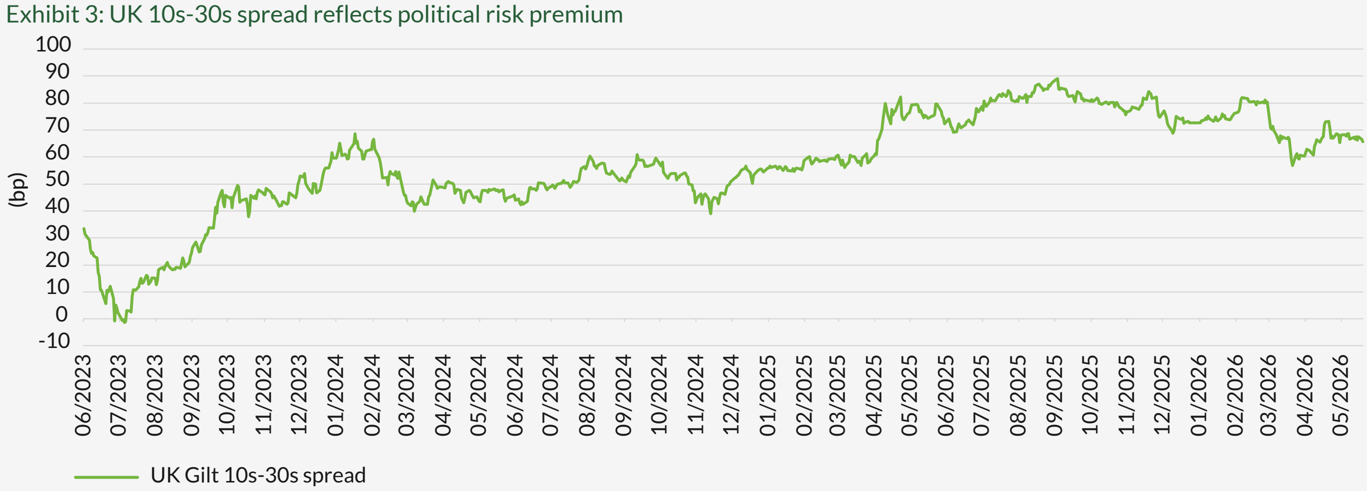
Who will buy increased Gilt supply?

The second source of sensitivity is finding a home for any increased supply of Gilts. The OBR's March 2026 materials show that public sector net financial liabilities were forecast to peak just under 83% of GDP in 2027/28 before falling thereafter, while net debt was estimated at 93.8% of GDP at the end of March 2026, a level last seen in the early 1960s. The UK needs to issue a large volume of Gilts into a global market where almost every developed market government is asking investors for more money.

Clearing that issuance is harder when the domestic buyer base is less captive than it used to be. "Defined benefit" pension schemes have historically been natural buyers of long-dated Gilts, particularly through liability-driven investment strategies. That demand was fairly price-insensitive schemes owned Gilts because they matched liabilities, and the UK Debt Management Office (DMO) built an issuance programme that reflected this structural demand. However, as schemes mature and move towards buyout, transferring liabilities to insurers, their long-duration Gilt allocations are replaced by more diversified insurer asset mixes.

Exhibit 3 shows the growing difference between the yield on 30-year Gilts and 10-year Gilts over the last three years. The spread partially reduced in March as the potential for rate hikes weighed on the 10-year driven by inflation concerns at the onset of the Iran conflict, but the upward trend has continued in recent weeks as investors have built the political risk premium into 30-year yields.

Exhibit 3: UK 10s-30s spread reflects political risk premium



Source: Bloomberg, 18 May 2026.

Do Gilts have a hedge fund problem?

The DMO has shortened the average maturity of its issuance to better reflect this changing demand, but long Gilts are still left relatively friendless. Its April syndication of a new 10-year Gilt raised £15bn from 281 separate orders, with international investors now accounting for over 25% of allocations, up from around 10% before the Bank of England (BoE) began quantitative tightening (QT) in February 2022. Demand can be found, but the clearing price may keep getting higher. Meanwhile, the BoE is no longer a buyer suppressing the term premium, and through QT it is giving duration back to the market at the same time the domestic buyer base is shrinking.

Finally, it is worth noting that hedge funds have become the dominant force in daily Gilt trading. Electronic trading platform data show they now account for approximately 60% of UK government bond trading volumes, up from 53% at the end of 2023, a figure the BoE governor, Andrew Bailey, has himself flagged as a potential source of "liquidity stress." The BoE reports that a small number of hedge funds account for more than 90% of net Gilt repo borrowing. These participants provide liquidity in calm markets, but they can withdraw or reverse positions rapidly under stress, amplifying moves in precisely the conditions where stability matters most.

Overall, we see the buyer base for Gilts as having transformed from predominantly price-insensitive, domestic and long-horizon to predominantly price-sensitive, leveraged and short-horizon. This is the context in which Starmer's fate matters. The Gilt market is not pricing an imminent UK default. The UK borrows in its own currency, has deep institutions, an independent central bank and a long history of meeting its obligations. But investors are asking whether the political system will respect the constraints required to stabilise the debt trajectory.

The market fears another Truss Tantrum

From here, political volatility probably has both a ceiling and a floor. The market already expects Starmer to go, limiting the shock value of further headlines, but the by-election and leadership process mean uncertainty cannot clear quickly. The leadership election process will be delayed until the by-election occurs, which is likely to be on June 18. The Gilt market will not know who the next UK prime minister will be until at least July.

In our brief review of UK premiership changes earlier, we skipped Liz Truss's brief tenure. The 2022 mini-budget crisis sparked an upwards spiral in Gilt yields which required the BoE's intervention. Ultimately there are too many moving parts for anyone to be sure what Gilts have priced in currently, but we suspect the market fears another such moment.

In our view, a new prime minister who relaxes fiscal rules would exacerbate the problems outlined above by increasing supply into a market already short of price-insensitive demand. However, we find it difficult to imagine the bond market's signals will be entirely ignored. Whether holding talks with hedge funds to test the waters on potential candidates for Chancellor, twisting the focus of previous statements on the bond market, or reaffirming their commitment to the fiscal rules, the leadership candidates are signalling they understand the importance of the constraints the Gilt market can place on their policy agendas. No one wants to be removed from office because of a surge in yields.

If we're correct, then as the Gilt issuance expectations associated with the new leader reduce, that political risk premium should recede. However, we would caution that if an increase in spending were to be funded by an increase in tax, keeping net Gilt issuance flat, there would be other market implications. Such an extension of the state would typically be inflationary, which would likely weigh on both sterling and Gilts. The growth implications will also be crucial given the fine balance between spending and tax receipts.

Three conclusions for investors

For fixed income investors, our most important conclusion is not that Gilts are uninvestable. At these yields, Gilts can offer value. But the risk of a further sell-off needs to be taken deliberately. The long end of the curve is where fiscal credibility, inflation uncertainty and duration supply are most directly priced. Shorter-dated Gilts remain more closely tied to the expected path of interest rates.

Our second conclusion is that government bonds cannot always be relied upon to provide portfolio protection in the way investors became accustomed to during the quantitative easing (QE) era. If a shock is disinflationary, Gilts may still rally. But if a shock raises inflation expectations or increases doubts about fiscal sustainability, yields can rise at the same time as risk assets fall. That is what makes the recent period uncomfortable. Political risk, energy risk and supply risk have all pointed in the same direction for Gilts.

Our third conclusion is that sovereign stress does not feed directly into UK corporate credit. A sell-off in Gilts driven by term premium, issuance or political uncertainty is a repricing of government duration, not a direct judgement on corporate solvency. Many UK bond issuers are global companies, banks and insurers with diversified revenues, strong liquidity and access to international capital markets. Their cashflows are not simply a function of UK fiscal politics. Higher government bond yields may raise all-in funding costs, but they do not automatically imply a deterioration in credit quality.

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