

High Yields and Stability: The Case for Gilts



Research Report

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Key Risks to Price Target

Not applicable

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Gilts are good diversification assets

The current context of geopolitical uncertainty and weekly upheaval is now so self-evident, it has become normalised. Uncertainty on this scale leaves investors facing the issue of what precisely to do about it.

Given the context there is a lot to be said for low risk, linear returns, that can be precisely calculated over a fixed time period. Gilts are a safe, useful place for parking cash assets, to obtain a fixed return that is usually higher than interest paid on bank cash deposits.

Over 2025, UK cash deposit rates reduced, the Bank Rate fell 1% over 2025 to 3.75%. Whilst we do not expect a similar drop in 2026, there could a further minor decline possibly 0.25%.

Gilts greatly help liability management in that maturing gilts can be used to pay off future debt when it falls due.

Gilt yields remain quite high

Gilt edged yields are providing relatively high short, medium, long term nominal returns. This is primarily due to the UK government's significant and ongoing borrowing requirements. This means primary issuance (issue of new gilts for government funding) will remain high possibly for the duration of this parliament (i.e. to 2029).

Furthermore, the Bank of England is selling gilt holdings that it acquired over the 'quantitative easing' phase from 2009-2013. This activity known as 'quantitative tightening' involves reducing its gilt holdings by £70bn per annum subject to market conditions. The Bank can achieve quantitative tightening by allowing its gilts to mature, and not buying new gilts, or more usually, via conducting market auctions of its gilts.

Academic studies conducted by the Bank suggest the first quantitative tightening phase, a £80bn programme of gilt sales increased 10 year gilt yields by 0.2%. The process of running down the Bank of England gilt inventory might take a few years, existing levels are £553bn having declined from £875bn a decade ago.

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A further reason why gilt yields remain high is to compensate holders for stubborn UK inflation and the possibility that inflation rises. Progress on reducing inflation has been slow. Current inflation of 3.2% is above the Bank of England's 2% target and over 2025 only moved marginally lower.

At present gilt yields are over 5% for gilt with 20+ years to maturity. The yield curve is upwards sloping, suggesting investors are requiring compensation for taking longer term inflation risks.

UK gilts carry a AA sovereign rating with a stable outlook. However in the context of rapidly rising global government debt levels there is concern that the present debt trajectory is unsustainable and inflationary. A risk factor with longer dated gilts is the reality that high cumulative inflation reduces the purchasing power of the gilt at redemption.

Gilt yields in the 4%-5.2% area offer attractive nominal returns compared to the 13 year period of sub 1% interest rates post the 2008/2009 financial crisis ie. recent financial history. More importantly, yields are attractive relative to other asset markets including UK equities currently offering around 3.5% and UK property now paying c. 2%.

The expectation is interest rates could well remain at similar levels over the next five years. The shape of the yield curve is upwards sloping meaning investors can lock in high yields for well over a decade.

Attractive for higher rate tax-payers

Both income and capital gains on gilts are tax free inside an ISA. So it worth having a high coupon medium /long dated gilt inside an ISA.

Outside an ISA, gilts' income is taxable (beyond the Personal Savings Allowance, currently £500: FY26) but capital gains on gilts remain tax free. It is better therefore to hold a low income gilt in a conventional investment account.

There are advantages in structuring a gilt portfolio to minimize income (due to investing in low coupon gilts) whilst obtaining most of the return as tax free capital gains. For example, the Treasury gilt 0.5% 2029 (maturing 31st January 2029) currently priced at 91 and yielding 3.645%.

When adjusted for basic rate taxpayers, the tax equivalent yield approximates 4.55% whilst for higher rate payers the yield rises to 6.07% and to 6.62% for additional rate taxpayers. The tax equivalent yield is effectively a yield adjusted for the tax bracket of the holder.

Gilts popularity surges

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According to Hargreaves Lansdown, 32% more clients held gilts in their accounts at the end of February 2025 v February 2024.

Other studies have shown that 'crowding trades' and 'over concentration' in certain sectors have led to a need for portfolio yield, i.e. assets that generate reliable cash for investors.

Recent events have supported portfolio diversification into areas that are insensitive to equity volatility. This suggests investors wanting to wait until the overall equity volatility calms down are searching for safe parking options.

Conclusion

Gilts yields offer attractive fixed income investments that could appreciate from current levels if inflation subsides or as relative safe haven investments, if as expected, high levels of uncertainty persist around global GDP growth.

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