

Investment Briefing, September 2025

Gilt market update

In this long-read briefing, we provide an update of developments in UK gilt markets, and ask the question – are gilts really ‘risk-free’? We provide a summary of our arguments, followed by a detailed analysis for those who want to dig deeper.

Are gilts really ‘risk-free’?

No – of course not. No investment is truly risk-free.

However, the UK’s regulatory framework effectively treats gilts as if they are.

For most asset classes, insurers must make a deduction for risk when calculating reserves. But for gilts, no such deduction is required. Insurance regulations assume gilts are risk-free.

In the world of Defined Benefit (DB) pensions, the new funding regime requires trustees to consider prescribed stress tests. Under the approach set out by The Pensions Regulator (TPR), these stress tests produce very favourable outcomes when gilts are held.

So, regulations clearly incentivise insurers and DB schemes to favour gilts over other assets, on the basis that they are a safe bet.

We don’t object to this – it helps lower the cost of UK government borrowing, which is in the national interest.

However, we’ve recently been asking: can holding gilts be justified by investment fundamentals alone?

Our conclusion: **gilts remain a good investment for DB schemes.**

Yes, risks exist – but they appear to be compensated by higher yields.

That said, since gilts are not risk-free, **some diversification of matching assets is sensible.**

Exposure to *safe haven* currencies may also offer protection against the tail risks associated with gilts.

In the rest of this long-read briefing, we share our analysis for those who want to dig deeper.

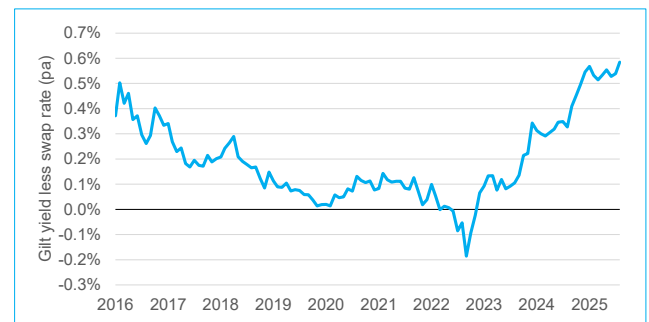
Gilt yield vs swap yield

Swaps are financial instruments which are often regarded as risk-free, largely due to the robust regulatory framework that governs them and the strength of the banks that back them.

Logically, you’d expect the yields on two assets considered risk-free – gilts and swaps – to be closely aligned. But interestingly, the gap between them has widened recently.

To illustrate this, Chart 1 below shows the history of the 10-year yield gap between gilts and swaps. This helps highlight how the divergence has developed over time.

Chart 1: 10-year gilt yield less 10-year swap yield since 2016

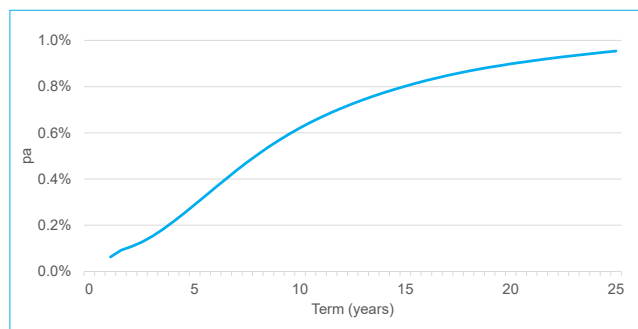


Source: Bank of England

The gap between the 10-year gilt yield and the 10-year swap yield has been increasing since the end of 2022,¹ and now stands at approximately 0.6% pa. A higher yield implies higher risk – the market seems to be suggesting gilts are riskier than swaps.

The difference between gilt and swap yields varies by term as illustrated in Chart 2.

Chart 2: Gilt yield less swap rate by term as at 2 September 2025



Source: Bank of England

If you're investing over a short horizon – say, two years – the return from gilts is only marginally higher than that from swaps.

But the longer the investment term, the greater the yield advantage. Over a 10-year period, gilts currently offer around 0.6% pa more than swaps.

So gilts must be risky?

Long-dated gilts currently appear very attractively priced relative to swaps. A 0.9% pa higher yield translates into paying around 20% less for a 25-year investment.

These elevated yields undoubtedly reflect a risk premium to some extent. Investors will be seeking compensation for potential concerns such as inflation, interest rate volatility and UK sovereign creditworthiness.

But there are other factors at play which we consider below:

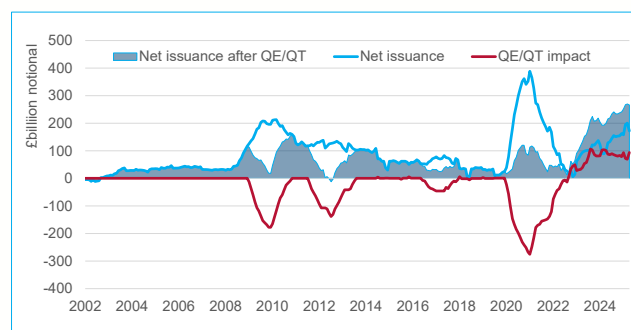
1. Gilt supply is increasing

Supply and demand dynamics have a huge influence on gilt pricing.

¹ The negative values in late 2022 reflected the support provided by the Bank of England to the gilt market

Chart 3 illustrates gilt issuance over the past two decades.

Chart 3: Gilt issuance



Source: Debt Management Office

The **blue line** shows rolling 12-month issuance. Two clear peaks stand out:

- **2009/10:** Following the global financial crisis, the Government borrowed heavily to bail out banks and support the economy.
- **2020/21:** During the Covid-19 pandemic, borrowing surged again to fund emergency support measures.

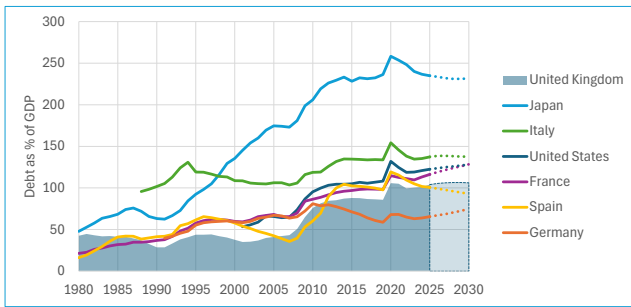
Government borrowing then fell in 2022 before rising sharply again. But this doesn't account for the impact of quantitative easing (QE).

From 2009 to November 2020, the Bank of England's QE programme involved purchasing large volumes of gilts, effectively removing them from the market.

In Chart 3, the red line represents the scale of QE, which peaked during the pandemic. The grey shaded area shows the net supply of gilts available to investors – significantly reduced due to QE.

Chart 4, based on data from the International Monetary Fund (IMF), shows how government debt has evolved over time relative to GDP across various countries.

Chart 4: Government debt levels (post 2025 projected)



Source: IMF

The first observation is clear: debt levels have generally increased over the past 50 years, and are now at historically high levels.

There was a sharp spike in 2020 due to the Covid-19 pandemic, but since then, debt-to-GDP ratios have stabilised.

The ratios are not projected to fall materially over the next five years – suggesting that governments are not planning significant efforts to reduce their debt burdens.

This may help explain why short-term gilt yields offer a relatively modest pick-up over swap yields. Markets expect debt levels to remain high, but stable, in the near term.

In response to the surge in debt during 2020, spreads on 10-year government bonds rose sharply in some countries – particularly Italy and Spain.

Yet, over this period, UK government bond spread (the gap between gilt and swap yields) did not move materially.

This provides a clear indication that QE has been a factor over recent years in suppressing gilt yields – and successfully maintaining a low cost of borrowing for the UK.

Since 2022, QE has come to an end, and the Bank of England has initiated quantitative tightening (QT) – selling gilts back into the market. This means that any cushioning impact that QE may have had on gilt yields is lost. Indeed, a consequence of QT may be that it is exacerbating gilt yield increases.

The Government is issuing large volumes of gilts while the Bank of England is also selling gilts under QT. The increased supply of gilts is reducing gilt prices and increasing yields.

2. Gilt demand is reducing

The demand for gilts is harder to assess but it's likely that pension scheme demand for more gilts has reduced over recent years. Most schemes already fully match their liabilities and do not need to buy more gilts.

Later in this briefing, we observe that demand for gilts from overseas investors may also fall.

On balance it seems possible that overall demand for gilts has reduced – which will put further upward pressure on yields.

3. Political disruption is unhelpful

Recent events demonstrate how domestic political uncertainty can influence government bond markets.

In summer 2022, Italian bond yields rose sharply amid the political instability that led to the resignation of Prime Minister Mario Draghi.

A similar episode occurred in late 2024 in France, where yields increased following the ousting of the French Prime Minister by the National Assembly.


The UK is currently facing its own political challenges, with considerable uncertainty surrounding the Government's fiscal position. Rising gilt yields are compounding the budget deficit by increasing the cost of borrowing.

Whether political uncertainty is directly driving gilt yields higher is difficult to determine. However, credit rating data (see below) suggests that investors should not currently be pricing in a significant risk of UK government default.

Credit ratings

A comparison of credit ratings across different governments is interesting. The table below provides this information using the Prudential Regulation Authority's system which is based on ratings of commercial credit rating agencies.

Country	Credit quality step ²
Germany	0
US	1
UK	1
France	1
Japan	2
Spain	2
Italy	3



This analysis suggests that the UK is in a relatively stable position compared to some other countries. Germany, for example, benefits from lower debt levels and stronger credit ratings. In contrast, Italy and France carry higher debt burdens and weaker credit profiles – with France also facing heightened political instability.

Despite this, recent events have shown that UK political developments can still influence gilt markets.

Earlier this summer, when Rachel Reeves appeared visibly distressed in the House of Commons, gilt yields spiked almost immediately. Markets seemed to interpret the moment as a sign that the Chancellor might be about to lose her position.

While it's difficult to pinpoint the exact cause of the market reaction, the most plausible explanation was concern that a new Chancellor might adopt a less fiscally disciplined approach – potentially increasing government borrowing.

The situation has remained tense. A similar market response was observed following Keir Starmer's reshuffle of backroom staff in recent days, which some interpreted as undermining Rachel Reeves' authority. Of course, since then there has been a full cabinet reshuffle, but the impact on gilt yields has been minimal – perhaps because Rachel Reeves retains her position.

Although hard to quantify, it seems likely that ongoing political uncertainty in the UK is contributing to upward pressure on gilt yields.

4. Higher inflation may be coming

One major advantage governments have over companies when it comes to repaying debt is their ability to control the money supply. Ultimately, a government can print more money to repay debt obligations.

While this approach ensures nominal repayments are made, it typically leads to currency depreciation and inflation, reducing the real value of those repayments.

As a result, growing concern that future inflation could erode the real value of UK government debt is likely contributing to upward pressure on gilt yields.

Overseas investors may look elsewhere

From the perspective of overseas investors, such monetary expansion may resemble a form of soft default – especially if it leads to a sharp decline in the value of sterling, the currency in which the debt is repaid.

Against such a backdrop, it seems reasonable for overseas investors to conclude that gilts currently have material risk. If such investors sell some of their holdings, this would be yet another factor driving down gilt prices and pushing up yields.

Impact on DB schemes

With all the uncertainty surrounding the gilt market, a natural question arises:

Should DB schemes continue to invest in gilts?

For schemes aiming to match liabilities, our assessment is that gilts remain appropriate.

Rising yields, inflation and a weakening pound may be detrimental to the broader UK economy, but could actually benefit DB scheme funding (noting of course that the real-world effect on pensioners could be significant):

- Overseas assets would appreciate in sterling terms.

² Credit quality steps represent the mapping of all commercial credit agencies various rating systems to credit ratings to the system used by the Prudential Regulation Authority

- The UK government would continue to repay gilts in nominal sterling amounts, meaning gilts would still effectively match sterling-based liabilities.
- Pension increase caps would limit the impact of high inflation on scheme liabilities.

Recent discussions with UK fixed income managers confirm a broad consensus:

- A UK government default remains highly unlikely, and gilts are still considered 'risk-free' in the sense that repayment is expected.
- That said, there is growing concern that inflation may be used as a long-term tool to reduce the real value of government debt.

Should trustees take any action?

LDI

Gilt yields have now surpassed the levels seen during the 2022 LDI crisis. However, the gradual pace of recent increases, combined with reforms to the LDI market, means that current conditions are not causing stress to leveraged LDI funds.

We believe the continued use of leveraged LDI remains appropriate.

Gilts or corporate bonds?

Gilts continue to be a suitable liability-matching asset. In fact, the additional yield over swaps makes them increasingly attractive relative to corporate bonds.

This is reflected in insurer pricing for buy-out policies, which are now less tied to corporate bonds, with several insurers choosing to invest more in gilts instead – a notable shift from two years ago.

Nonetheless, diversification remains a sound investment principle. Given the likelihood of ongoing volatility in the gilt market, maintaining some exposure to corporate bonds alongside gilts is a prudent approach.

Overseas assets

A UK economic shock could lead to sterling depreciation. Trustees should therefore review their scheme's currency exposure and consider whether overseas currencies might offer useful protection.

Summary

While gilts are often treated as risk-free within regulatory frameworks, a recent divergence in gilt and swap yields suggests that gilts are becoming riskier. However, our analysis suggests a more nuanced reality.

Factors behind the recent increase in gilt yields are likely to include increased gilt issuance, QT, reduced demand, political disruption and concerns about higher inflation.

Despite these challenges, gilts remain a valuable liability-matching asset for UK DB schemes. Their yields are currently attractive relative to swaps and corporate bonds, and they continue to align well with sterling-based liabilities. However, diversification and careful monitoring of currency exposure are prudent steps for trustees navigating an increasingly complex investment landscape.

Further information

For further information, please contact your usual [First Actuarial consultant](#).