The Return Of The Real 'Liz Truss'

What Can Go Wrong in Britain, Probably Will Go Wrong

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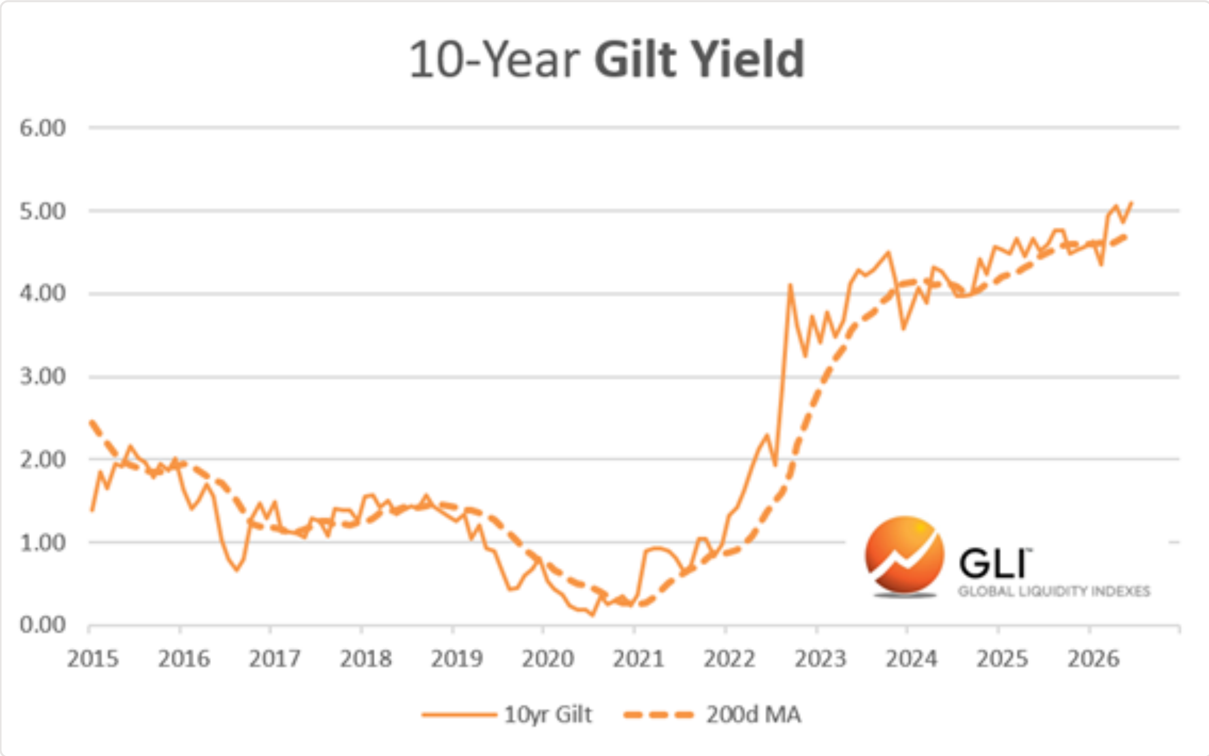
In markets, there are no unrelated events. 'Big State' is fast-becoming the policy 'norm' everywhere: are we are being dragged helplessly towards the Chinese model? Big government has a rapacious appetite and needs feeding. This report adds context to Britain's economic deterioration and fiscal profligacy. It is set against a backdrop where even Japan, the World's major creditor nation, faces a sinking currency and persistently rising bond yields. Japanese investors, themselves, have large investments in Europe: mostly purchased when Japanese interest rates were relatively low.

Socialist economic experiments have a particularly poor record. Soviet Russia, China, Cuba, Venezuela and Mitterrand's France in the early 1980s all offer cautionary examples. Britain now faces some of the highest borrowing costs among major economies, and the outlook under Andy Burnham's new Government, committed to a bigger state and more left-leaning policies, looks bleak. Yet with 10-year gilt yields testing 5%, international bond investors may still impose discipline on the Government's spending plans. **No country is an island in economics or finance.**



How much of this is bad policy, and how much is simply poor presentation? The “Liz Truss moment” remains seared into recent political memory. The familiar story is that unwise fiscal policies during her brief premiership crashed the UK bond market, which has never fully recovered. UK bonds did sell off sharply, and the Bank of England was forced into emergency intervention. Yet the truth is more nuanced: Truss had a presentation problem; today, UK Labour has an economic-policy problem.

Subscribed

Main Points

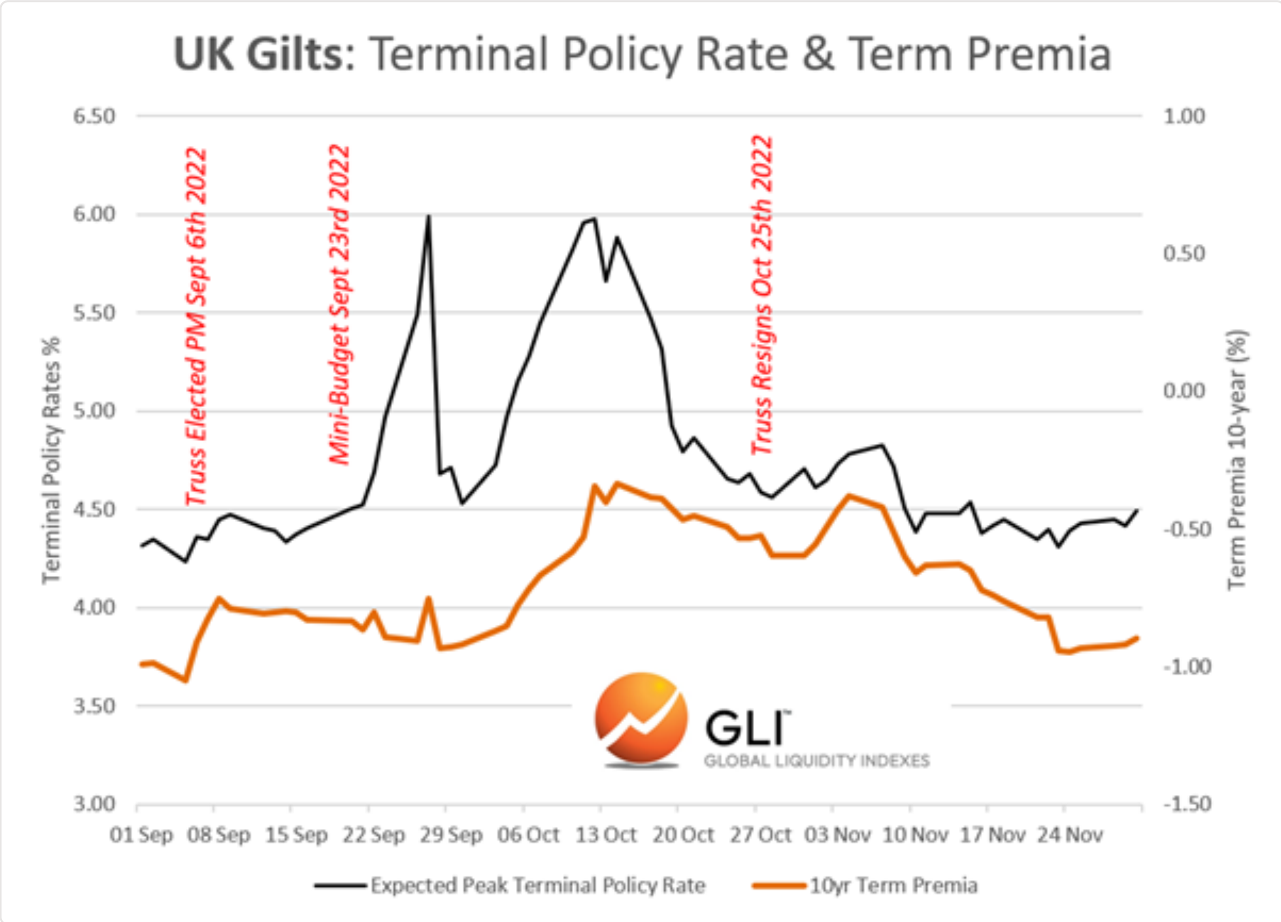
> - The 'Liz Truss' episode was driven mainly by higher expected policy rates, not by a lasting rise in UK sovereign-risk premia
> - Rising term premia are the clearest market signal of concern about fiscal credibility and long-run sovereign risk
> - Labour (socialist) governments do not inherently face higher borrowing costs, but today's fiscal backdrop is far weaker than in the earlier more benign Blair era
> - A further rise of around 100bp in term premia is plausible if policy continues to weigh on enterprise and investor confidence

Back To The Future

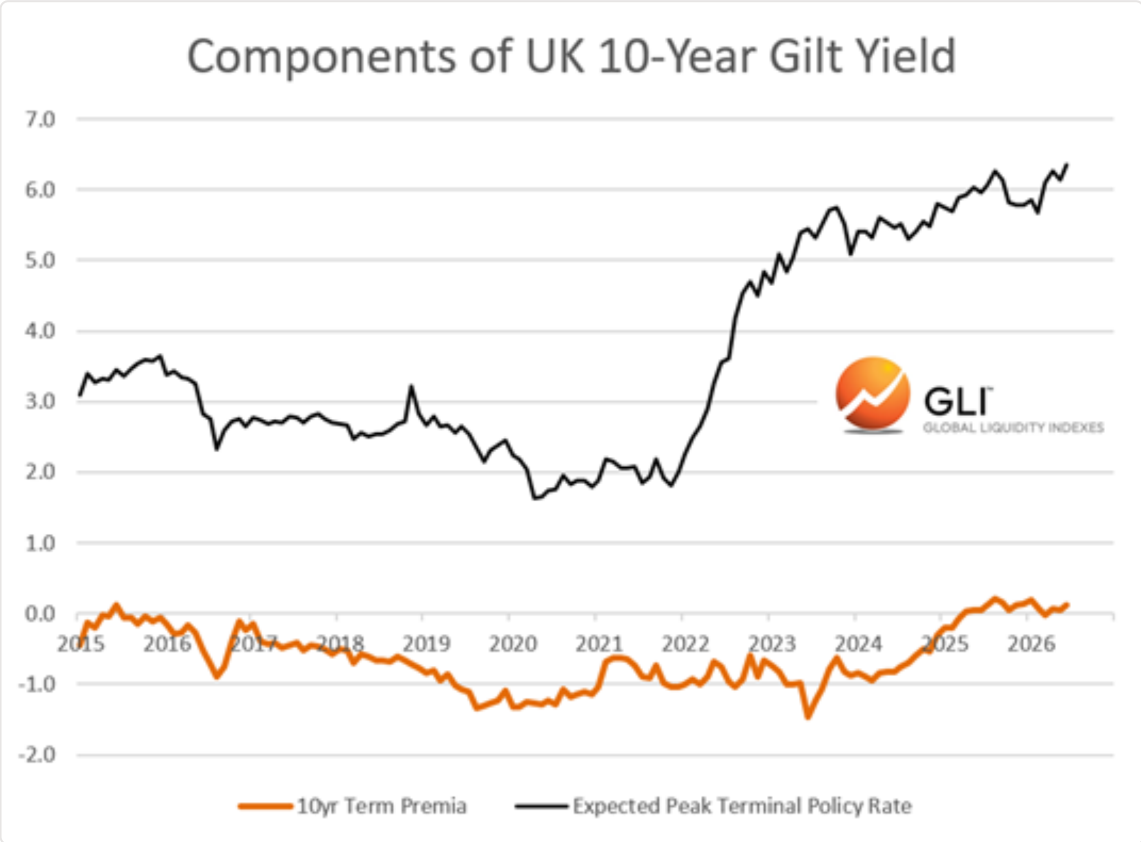
During the Truss-led sell-off, higher gilt yields were driven mainly by rising expected policy rates, not by a sustained increase in the risk premium attached to UK sovereign debt. Foreign capital did not shun the UK; Britain's higher inflation rate justified higher policy rates, and those increases pre-dated the Truss premiership.

Bond yields have two key components: expected terminal policy rates and term premia, the compensation investors demand for holding a bond to maturity. Sovereign-risk concerns show up most clearly in rising term premia.

The chart below tracks these two components through the Liz Truss premiership. Term premia rose briefly, by around 75bp, but fell back within weeks of her departure. Expected terminal policy rates rose by at least 150bp, but also settled back quickly after Truss left office.



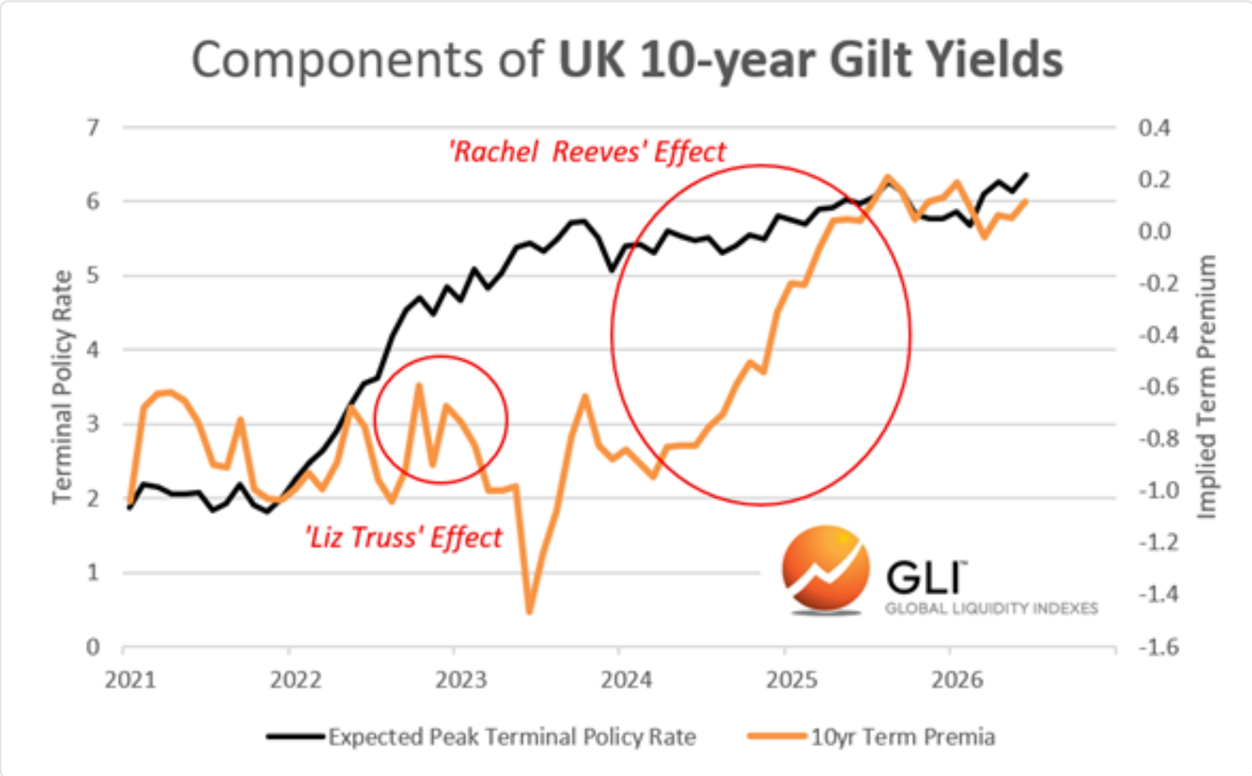
In practice, the real damage to UK bond yields occurred earlier, as expected policy rates rose through much of 2022. This was a period of sharp monetary tightening, led by the US Federal Reserve after the COVID-era bubble. Since then, UK policy-rate expectations have drifted slightly higher, while rising term premia have added further pressure. That recent increase in term premia is the clearest measure of sovereign risk, and it has been directly associated with the incoming Labour administration.



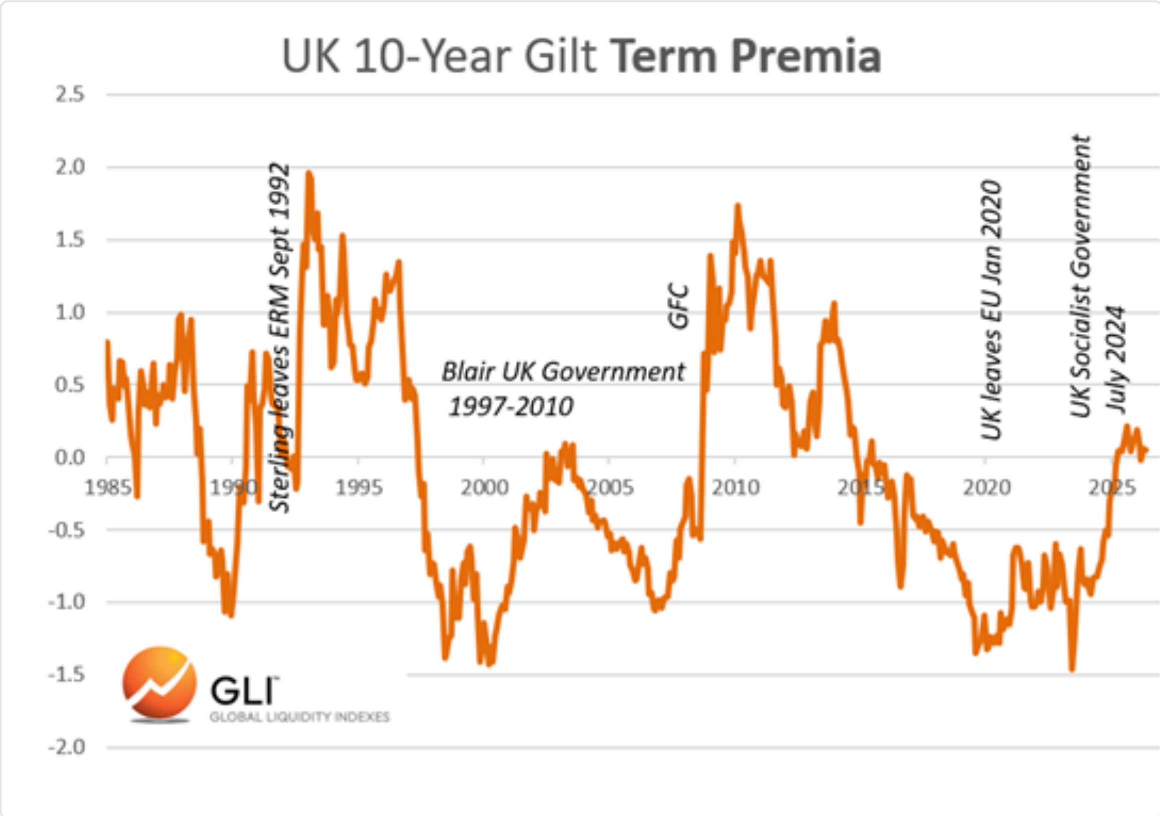
This is evident in the co-movement of expected Bank of England policy rates and gilt term premia from 2021 onwards, spanning both the Truss premiership and the subsequent deterioration in public finances under Labour Chancellor Rachel Reeves, who on day one waived through a whopping £9 billion wage boost to government workers. A staggering near-30% of the British population now receive some form of State benefit. The rot did not start with this Labour Government: the tipping point was COVID and the generous hand-outs from previous Tory governments. All parties have fuelled the growth of 'Big Government', but the trend is accelerating.

Where Is 'Liz'?

The bottom line is that the popularised "Liz Truss effect" is difficult to isolate. By contrast, the unfavourable and persistent impact of Chancellor Reeves' policies on term premia is plain to see. These effects began when Labour took office in July 2024 and have since added more than 100bp to Britain's long-run borrowing costs.



The next chart adds context to UK term premia. Two points stand out. First, term premia have been higher at other moments, including in the wake of the 2008/09 global financial crisis and following sterling's ejection from the European Exchange Rate Mechanism in 1992 ("Black Wednesday"). Second, Labour governments do not automatically face higher borrowing premia, as shown by the low term premia enjoyed during the business-friendly years of the Blair Government.



Big Government Equals Big Bond Yields

The key differences between the late 1990s and today are clear: Britain's welfare bill is much larger; tax rates have reached onerous levels; and, unsurprisingly, economic performance has weakened. In short, the money has run out. This brutal fact helps explain why British governments of all political stripes have become so short-lived: two years now seems to be the longest any leader can survive.

Looking ahead, what should markets expect from Burnham's new Chancellor, John Healey? His hands are largely tied. But if the new government stubbornly persists with 'Big State' and left-wing policies that sap enterprise, markets are likely to punish it by demanding still-higher bond yields. UK gilt term premia should therefore be monitored closely.

Britain is not alone in expanding State spending and raising public debt, but, after years of bad policies, she is increasingly an outlier, without the offsetting benefits of a viable reserve currency, like the US dollar. Term premia and UK gilt yields could easily rise by another 100bp. But, herein, lies a warning to profligate governments everywhere: **the international bond vigilantes are watching you.**