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"Britain's Paradox: A Weak Economy, Interesting Assets." In this article Westminster investment strategist Peter Lucas turns his attention to Britain. Despite the many problems the country faces, Peter believes all is not lost and financial assets are starting to look increasingly attractive.



Britain has a problem. Economic growth is weak, productivity is poor, government debt is high, taxation is rising and confidence in the direction of economic policy is fragile. Yet UK financial assets are relatively cheap. For investors, the important question is therefore not whether Britain has problems - it plainly does - but whether those problems are already sufficiently priced in.

Let's start with productivity. Britain has struggled to generate meaningful productivity growth for years. This matters because productivity ultimately determines how quickly living standards, wages and tax revenues can grow without creating inflation. An economy that cannot raise output per worker eventually finds itself choosing between higher taxes, more borrowing and poorer public services.

There are many explanations for Britain's productivity problem, but two stand out. First, there is the public sector. The debate about public services tends to focus on the amount being spent rather than the efficiency of that spending. Despite recent improvement, public-service productivity in 2025 was still 2.5% below its pre-pandemic level. More resources have not generated a commensurate increase in output. That matters when the state absorbs such a large proportion of national resources. If additional inputs fail to produce proportionate additional outputs, governments must eventually choose between ever-increasing expenditure and reform. Britain has generally found increasing expenditure politically easier.

Second, for much of the period since the financial crisis, interest rates were extraordinarily low relative to nominal economic growth. While cheap money was intended to stimulate investment, prolonged periods of artificially cheap capital can also weaken capital discipline. Marginal businesses survive. Financial engineering becomes more attractive. Capital flows into existing assets rather than necessarily financing productive new ones. The pressure to allocate capital towards activities offering genuinely high economic returns is weakened.

Britain therefore doesn't simply need more investment. It needs more productive investment. But the higher interest rates required to restore capital discipline could also leave the country in financial difficulty - more on this shortly.

Businesses now face higher taxation, elevated labour costs and uncertainty about what comes next. A tax-and-spend strategy may support measured GDP in the short term, but if the additional expenditure is relatively unproductive while the taxes required to finance it weaken employment, entrepreneurship and private investment, the longer-term result can be lower potential growth.

This feeds directly into Britain's increasingly uncomfortable fiscal arithmetic. Public-sector net debt stood at 93.8% of GDP in August, while borrowing in the first five months of the financial year was £8.1 billion above the Office for Budget Responsibility's forecast. High borrowing costs compound the problem as more debt is refinanced at today's yields. Weak productivity constrains growth. Weak growth limits tax revenues. Higher borrowing increases the interest bill. Higher taxes risk further weakening investment and confidence. The government finds itself stuck between a rock and a hard place.

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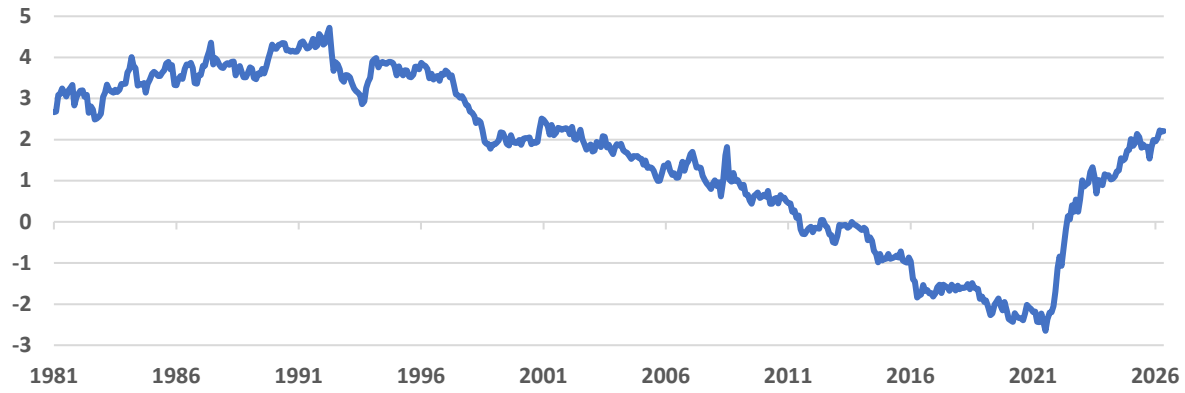
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Many highly indebted governments have historically controlled their debt burdens through financial repression: holding interest rates below the rate of nominal economic growth. If nominal GDP rises faster than the interest cost on the debt, the debt burden can gradually decline relative to the size of the economy. This strategy was used to good effect in the period after the Second World War.

This makes gilt yields particularly important. High borrowing costs are already putting pressure on the public finances, while gilts appear relatively cheap compared with other major government bond markets. Some of that premium may reflect heavy issuance and structural changes in demand. Defined-benefit pension schemes, historically important buyers of long-duration gilts, are becoming less important as schemes mature and their need to hedge long-term liabilities declines. But some of the premium may also represent genuine fiscal risk.

And here Britain faces an unusual complication. Roughly a quarter of the outstanding gilt stock is inflation-linked. Unlike conventional gilts, both the principal and coupon payments on these bonds rise with RPI. Britain therefore has less ability than many countries to inflate away its debt burden. Inflation reduces the real value of conventional fixed-rate debt but simultaneously increases the value and servicing cost of its index-linked liabilities. The traditional route of defaulting by the back door is therefore less effective. That doesn't make an outright UK sovereign default remotely imminent. Britain borrows in its own currency and retains substantial monetary flexibility. But the unusually large linker stock narrows the government's options if fiscal conditions become significantly worse.

UK Index-Linked Gilt Yields, 1982-2026 (All stocks series)



Source: FTSE Actuaries; ESCoE British Government Securities Database; Bloomberg

For investors, this produces an interesting conclusion. If high government borrowing costs ultimately lead to financial repression, conventional gilts should initially benefit as nominal yields are suppressed. But if repression subsequently produces higher inflation, index-linked gilts may be the better place to be. And they are not obviously expensive. The 10-year UK breakeven inflation rate - broadly, the inflation rate at which conventional and index-linked gilts would produce equivalent returns - is currently around 0.3 percentage points above HICP inflation, below the long-run average of around 0.7 percentage points.

But there is a possible sting in the tail. The more valuable inflation protection becomes to investors, the more expensive it becomes to the government. In an extreme fiscal scenario, a government struggling with indexed liabilities could eventually be tempted to alter the effective value of that protection. This isn't entirely hypothetical. From 2030 the methodology used to calculate RPI is due to change to incorporate CPIH methods and data. The economic value of inflation protection can therefore change without formally restructuring the bonds themselves.

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Linkers provide protection against inflation, but not complete protection against the sovereign that ultimately defines the inflation index. That is what gold is for.

Sterling represents another potential adjustment mechanism. The pound appears slightly expensive on longer-term valuation measures. Relatively high UK interest rates can support it for some time. But if policymakers eventually suppress borrowing costs while inflationary pressure persists, sterling could become one of the principal release valves.

Britain is also vulnerable to events elsewhere in Europe. The UK may have left the European Union, but it has not left the European economy. The EU currently accounts for around 41% of UK exports and 49% of imports. A renewed Eurozone debt crisis would therefore hit Britain through trade, confidence and financial conditions. As discussed in my recent article on France and Germany, a serious downturn in Britain's largest trading partner would arrive at an exceptionally inconvenient moment.

Domestic pressures add further uncertainty. Housing costs, strained public services, weak real-income growth and sharp disputes over immigration and asylum policy are fuelling political discontent. For investors, the concern is that deepening social and political divisions make difficult fiscal and structural reforms harder to implement.

Yet none of this automatically makes UK equities unattractive. This is where the distinction between the economy and the stock market becomes crucial. The UK equity market is dominated by mature, internationally exposed businesses in sectors such as energy, mining, banking and pharmaceuticals. It has relatively little exposure to the expensive technology companies that dominate the US market. Britain is predominantly a value market at a time when investors have spent years paying increasingly large premiums for growth. Many FTSE companies also generate much of their revenues overseas. A weak domestic economy is therefore not necessarily disastrous for their earnings. Indeed, if Britain's fiscal problems ultimately result in sterling weakness, the translated profits of international UK-listed businesses could benefit.

Domestically focused smaller companies are a different proposition. They are much more directly exposed to weak consumer demand, taxation, property and domestic investment. Large international companies can prosper even when the economy in which they happen to be listed does not.

So where does this leave investors? Britain's structural economic problems are considerable. Productivity is weak, public-sector reform has been inadequate, debt is high and the fiscal deficit remains large. Yet markets are not economies. UK equities are cheap and contain precisely the sort of value, commodity and internationally exposed businesses that could perform relatively well in a more inflationary global environment. Gilts also appear relatively cheap, with inflation-linked gilts potentially more interesting if the eventual response to fiscal pressure is financial repression.

Sterling looks the most vulnerable. Initially, that vulnerability may be greatest against the US dollar, particularly if the next debt crisis begins in Europe. Longer term, however, as I argued last November, Asian currencies could predominate, supported by lower debt levels and stronger external finances.

Britain therefore appears to offer investors an unusual combination: a weak economic story, but some increasingly interesting financial assets.

Peter Lucas - October 2026

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