



Watch Out for Dark Fiscal Clouds (and their Silver Linings) in 2026

As 2025 drew to a close, most of the attention, rightly or wrongly, was on the risk of a sharp stock market correction. Given that almost all equity markets are at, or close to, all-time highs, as well as the growing concentration of value among a tiny number of stocks, this is understandable.

However, this focus on global equity markets may be overshadowing an even bigger risk: the rapidly declining fiscal health of national governments, particularly in Europe. That, of course, includes the United Kingdom.

Over-reliance on tax hikes

In its recent budget, the Keir Starmer government relied almost exclusively on tax hikes to try to reduce its budget deficit. The good news for the government is that the broad market reaction was rather muted.

However, the government cannot rely exclusively on tax rises for long, especially given their broad contractionary effects. Also, the reports of wealthy individuals leaving the country for lower-tax regimes, while perhaps a little overblown, should not be entirely ignored.

It's a similar story in France, where each attempt by the government to reduce spending levels leads to a new political crisis. Separate reports in the autumn of both France and the UK potentially needing an International Monetary Fund (IMF) bailout, while nipped in the bud at the time, should not be dismissed out of hand.

Both countries have seen their public debt-to-GDP ratio soar in recent years. More important still, the yields on long-duration UK and French bonds registered decade highs in 2025. Recent moves in the Japanese bond markets suggest that bond yields are likely to continue rising into 2026.

"A critical indicator"

The yields on ten-year Japanese government bonds jumped to 1.95% in mid-December, marking the highest level since 2007. As Bloomberg noted, "this shift is considered a critical indicator of changing global liquidity conditions as we approach 2026, breaking a decades-long stagnation in interest rates."

Japan's government is not just struggling to rein in spending, like the UK and France, it is looking to massively increase it. This has prompted a sharp, almost parabolic surge in the yields for the country's 20- and 30-year bonds, especially after the Bank of Japan warned of a possible rate hike.



The reversal of Japan's decades-long trend of low yields will certainly be a trend to watch in 2026, for two key reasons:

1. Japan was the first country to embrace negative and even zero interest rates, which it did with abandon, and now has the largest gross debt-to-GDP ratio of any advanced economy (236.7% in 2024). However, unlike most Western economies, domestic investors hold much of the public debt.
2. Thanks to the yen carry trade, Japan has been an abundant source of essentially free money for large global investors. Since the country's interest rates were near zero (or negative) for decades, big global investors were able to borrow trillions of Yen for almost free, which they then ploughed into dollars or rupees and bought high-yielding assets like tech stocks. Now that the yields on Japanese bonds are rising, the once-free money is suddenly charging interest and the differential between US debt and Japanese debt is narrowing, prompting some to wonder: are we about to see another painful unwind of the carry trade, similar to what investors experienced on the 5 August 2024?

It's not just the unwinding of the carry trade that could affect global liquidity conditions. For 34 straight years, Japan was the world's largest creditor nation – a mantle that now belongs to China. With Japanese bond yields rising, Japanese bond investors no longer need US bonds. If treasury demand falls, the yields will inevitably rise, which could in turn further tighten liquidity conditions.

As for the Bank of Japan (BOJ), it finds itself in a bit of a bind. If it continues to raise rates to try to keep a lid on inflation, which has stayed above the BOJ's 2% target for 43 straight months, it runs the risk of pushing bond yields even higher, piling yet more pressure on the government's finances.

Pertinent questions for investors

As the fiscal clouds gather, investors should ask themselves:

- To what extent will the end of Japan's multi-decade low interest rate regime impact liquidity conditions globally in 2026?
- Will it exacerbate the debt crises of other advanced economies?
- Will central banks be able to pick up the slack by lowering rates?
- Will governments like the UK's be able to finally rein in their excess spending?
- If not, could there be a buyers' strike of government debt in one or more of the world's major economies, as almost happened during the UK's 2022 Gilt Crisis?
- Could the IMF be called upon to bail out a G7 economy, as happened to the UK in 1976?

A buyer's strike and/or an IMF bailout, while highly unlikely, cannot be completely ruled out. Especially as most large advanced economies are now grappling with the twin challenges of record government debt and surging bond yields.



For investors, the challenge is clear, albeit far from simple: to decide whether it makes more sense to hold most of one's money in frothy equity markets or the bonds of fiscally challenged governments.

Time, the key

Timelines are obviously important here. From a longer term perspective, we should all be more concerned about the pressures building in global bond markets. In the short term, however, you can lose a lot more money on equities.

Meanwhile, both asset classes are highly interlinked. Indeed, it is quite possible that bond market jitters could end up infecting global stock markets. Commodities and private credit, particularly at the shorter end, offer additional options.

Ultimately, the decisions you make will depend on your own particular time horizon. If you have only a couple of years left until buyout, it makes little sense to take unnecessary risks. As such, a small equity allocation (say, 10-20%) makes more sense than a large private credit allocation.

Meanwhile, even as the dark fiscal clouds gather, keep in mind that some of those clouds may have silver linings. For example, the Labour government's budget, while far from perfect (for reasons already mentioned), did not spark a major sell-off of UK bonds. The Marcon government has already survived multiple political crises and may continue to do so.

Also, the UK and the US are trailing the EU when it comes to cutting base interest rates. If both countries cut rates in the coming weeks, as the US has already begun to do, it should help to relieve some of the fiscal pressure on their respective governments, at least (and at probably most) in the short term.

You never know, it may even be enough to spark a Santa rally.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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250 Fowler Avenue
Farnborough Business Park
Farnborough GU14 7JP

Marlborough House
Victoria Road South
Chelmsford CM1 1LN

T: 01252 894883
E: enquiries@cartwright.co.uk
W: cartwright.co.uk

