PICTET WEALTH MANAGEMENT
CIO OFFICE & MACRO RESEARCH
23 September 2022

UK - BUDGET UPDATE

MINI BUDGET, MAXI RISKS

Author

CIO OFFICE & MACRO RESEARCH

SUMMARY

- The "mini-budget" announced by the UK's new Chancellor of the Exchequer, Kwasi Kwarteng, marks a regime shift away from the fiscal cautiousness that has prevailed in recent years including under Kwarteng's predecessor, Rishi Sunak.
- The focus of the fiscal package was lower taxes for households and corporates, with the aim to re-energise business activity (and ultimately tax receipts). The Institute for Fiscal Studies says the tax cuts are the biggest in the UK since 1972.
- The UK government has also announced it will establish an 'Energy Price Guarantee' designed to cap spiralling energy costs for households and businesses. This measure could potentially cost GBP150 bn, although it hopes to keep that off-budget.
- The government has raised its annual debt issuance plan by a substantial GBP 72bn (to GBP 234 bn) in fiscal year 2022-23.
- Financial markets are mostly viewing the glass as half-empty—saluting the efforts to curb short-term energy costs, but much more worried about the step-up in borrowing needs and the risk that the Bank of England may have to tighten policy even more than anticipated, causing even more pain to the economy in 2023.
- Compounding the funding pressure on the government, the Bank of England said at its last policy meeting it would also sell GBP 80bn of its bond holdings over the next 12 months, even as it raised the bank rate by another 50bp to 2.25%. In other words, there is a lingering market fear that the UK may fall into a negative macroeconomic equilibrium.
- We are raising our forecast for the terminal Bank Rate to 4.0% (from a previous 3.25%), although we do have some worries that the ongoing erosion of the Bank of England's credibility may push it to tighten even more.
- From a bond-market perspective, we have revised our 10-year Gilt forecast to 4.2%. We remain underweight UK government bonds.
- We remain cautious on sterling in the short run as a loose budget stance will compound the UK's current-account vulnerabilities.

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Mini-budget: A break with Tory tradition

In early September, Liz Truss was chosen by the Tory party to replace Boris Johnson as prime minister. She was elected on a platform that promised to unleash the UK's growth potential, largely through lower taxation. This represented a **significant break from the traditional fiscal prudence** of the Tory party, including that of the Chancellor of the Exchequer in Johnson's government, Rishi Sunak (who lost the Tory party leadership contest to Truss).

Truss outlined her broad views on the UK economy in a 2012 essay entitled 'Britannia Unchained: Global Lessons for Growth and Prosperity', to which the new Chancellor, Kwasi Kwarteng, also contributed. In the essay, Truss makes clear she believes in the virtues of **low taxes to reinvigorate activity**, echoing the tenets of 1980s Tatcherism. But whatever her plans for the longer term, Truss's most immediate problem is the huge surge in energy prices, which is throttling consumer spending and confidence. **Truss's response has been the introduction of an 'Energy Price Guarantee'**, a mechanism to cap the rise in average annual utility bills for households at GBP 2,500 starting in October.

On the heels of the Guarantee, Kwarteng today unveiled a 'mini-budget'. Its main measures are as follows:

- **Lower personal taxes:** The planned increase in national-insurance tax (the equivalent of a payroll tax) of 1.25 percentage point from 6 November is cancelled. The lowest personal tax rate of 20% is cut to 19%. The top tax rate of 45% (for incomes above GBP150,000) is eliminated. Taxes on alcohol are to be frozen starting in February.
- **Lower corporate taxes:** The planned rate increase to 25% is cancelled. The corporate tax rate stays at 19%.
- **Relief on stamp duty:** The threshold for stamp duty on housing transactions is being raised to GBP425,000 from GBP300,000.
- **Bonuses:** The cap on bonuses for bankers is being eliminated.

From a macroeconomic standpoint, we believe the **budget does not represent a game-changer for the UK's near-term outlook**, which remains very challenging. The Bank of England's latest forecast is for a 0.1% quarter-on-quarter drop in GDP in Q3 2022, after a similar fall in Q2. This means the UK's economy is in 'technical recession' (defined as two quarters of negative growth), even though the lingering resiliency of the labour market may mean it is not yet in a full-blown economic recession. But **it may just be a question of time before a weakening economy (and in particular weaker consumer spending) translates into a deteriorating labour market.**

We maintain our UK GDP growth forecast of 2.9% this year and -0.6% next year, although there are **large downside risks**, especially to the 2023 forecast. We note that while the Energy Price Guarantee will limit utility bill increases, the previous surge in energy prices is continuing to place a significant strain on households. **Private-spending data for September already hints at a significant deterioration in consumers' financial health**, and this may continue as we approach the crucial year-end shopping season. Another drag on economic activity is the tightening of monetary

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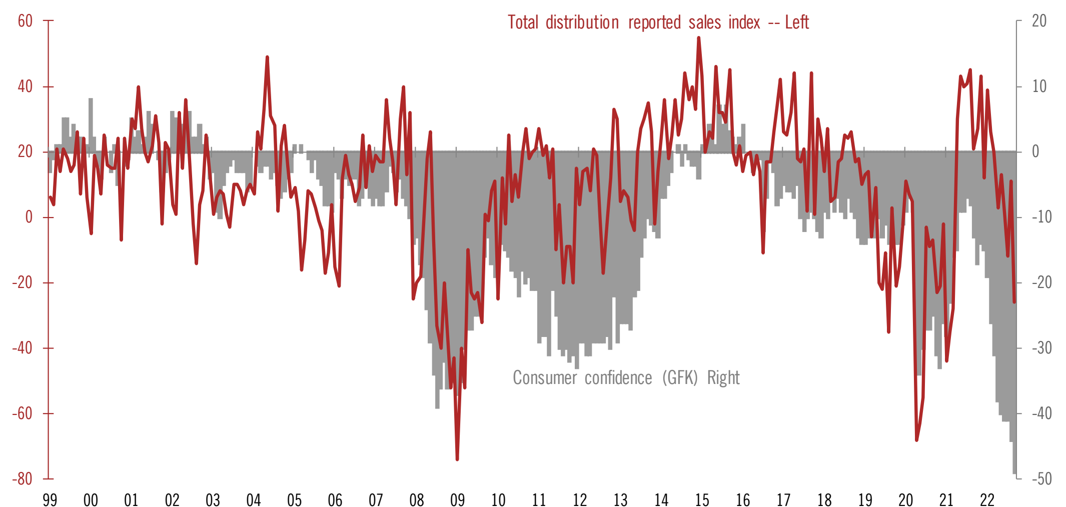
and financial conditions, with the **interest-rate sensitive housing sector likely to be among the hardest hit**. It is unclear whether the stamp-duty provision contained in the mini-budget is a true game-changer.

From a Bank of England (BoE) standpoint, we think members of its Monetary Policy Committee will want to **partially offset the fiscal largesse through additional monetary tightening**, for fear of fueling already volatile inflation expectations. We now see a **75bp rate hike** coming in November (versus our previous forecast of 50bp). It is worth noting that the money market is pricing in an even bigger hike (almost 100bps). We now forecast that the BoE will hike the Bank Rate until it reaches a terminal rate of 4.0% (versus 3.25% in our previous forecast).

We think there is a **risk of a 'credibility regime shift' for the Bank of England**. Fearing a further erosion of credibility, we believe the Bank of England could be tempted to tighten policy even more, especially to assuage foreign investors (and make UK debt more appealing). But satisfying the demands of foreign investors could end up trumping worries about the domestic consequences of tight money, conjuring up memories of the currency crisis that forced the UK out of the Exchange Rate Mechanism in 1992.
Nonetheless, our central scenario is that the Bank of England will manage to deal with the current policy challenges it faces and maintain its independence in the process. In the coming weeks, we **would not rule out some dialing back on its plans for 'active' quantitative tightening (active bond sales) in the context of spiralling long-term yields.**

CHART 1: UNCLEAR WHETHER MINI BUDGET WILL HELP UK CONSUMERS, WHO HAVE STARTED TO FLINCH



Source: Pictet WM – CIO Office & Macro Research, Bloomberg Finance LP, 23 September 2022.

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UK gilts: on course for emerging-market status?

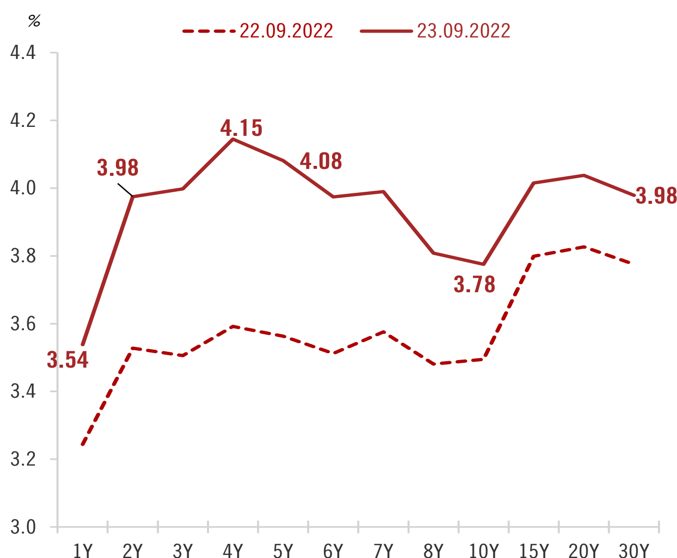
Even allowing for the fact that the tax cuts announced in the mini-budget were larger than expected, the magnitude of the reaction on the UK gilt market has been massive. As we type, yields are surging across the curve, ranging from +50 bp on the three-year gilt to +30 bp on the 10-year yield (*see chart 2*). In the wake of the mini-budget and the Energy Price Guarantee scheme, the UK Debt Management Office (DMO) has revised up the government's net refinancing requirement for fiscal year 2022-23 from GBP161.7 bn to GBP234.1 bn. This will bring net gilt (i.e. bond) issuance to GBP193.9 bn, an increase of GBP62.4 bn.

Although the increase is significant (+47%), the scale of the gilt sell-off leads us to believe that the market's worries go beyond expectations for a surge in gilt issuance. In our view, the rout in the gilt market is linked to concerns that the BoE, which needs to seriously tackle inflation to restore its credibility, is set on a **collision course with the government**.

Market participants are pricing in a terminal bank rate above 5.3% next year, well above our revised forecast of 4.0%. The market expects the BoE to have to tighten much more to counter the medium-term inflationary impact of the tax cuts and energy price caps. Although a Bank Rate above 5% seems high in a context of weakening growth, **we do expect market participants to continue testing the BoE's resolve to fight inflation**.

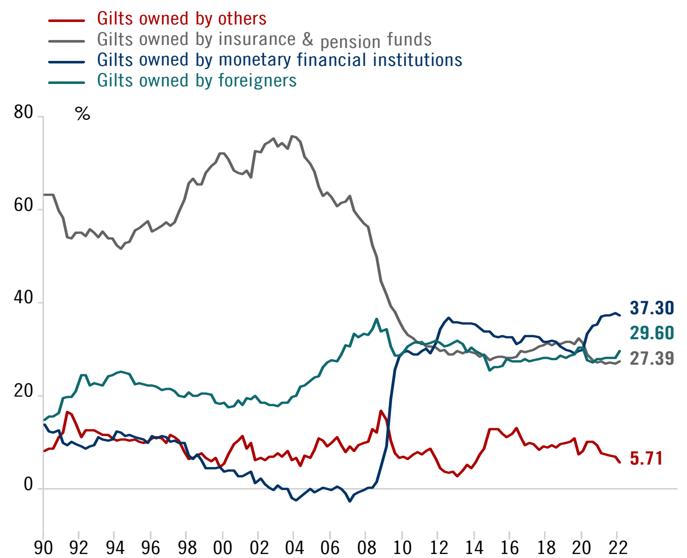
Given that foreigners hold almost 30% of all UK gilts outstanding and that the BoE plans to reduce rapidly its own 37% share through quantitative tightening, **yields might need to rise further from current levels to attract marginal buyers**, especially foreigners (*see chart 3*). Given the steep decline in sterling, the BoE might have to hike very aggressively to maintain its inflation-fighting credibility and gilts' attractiveness. The dilemma facing the BoE and UK gilts bears some resemblance to the challenges one periodically sees in emerging markets.

CHART 2: UK GILT YIELD CURVE



Source: Pictet Wealth Management, Factset, 23.09.2022

CART 3: SHARE OF GILTS HELD IN % OF TOTAL OUTSTANDING



Source: Pictet Wealth Management, Factset, 23.09.2022

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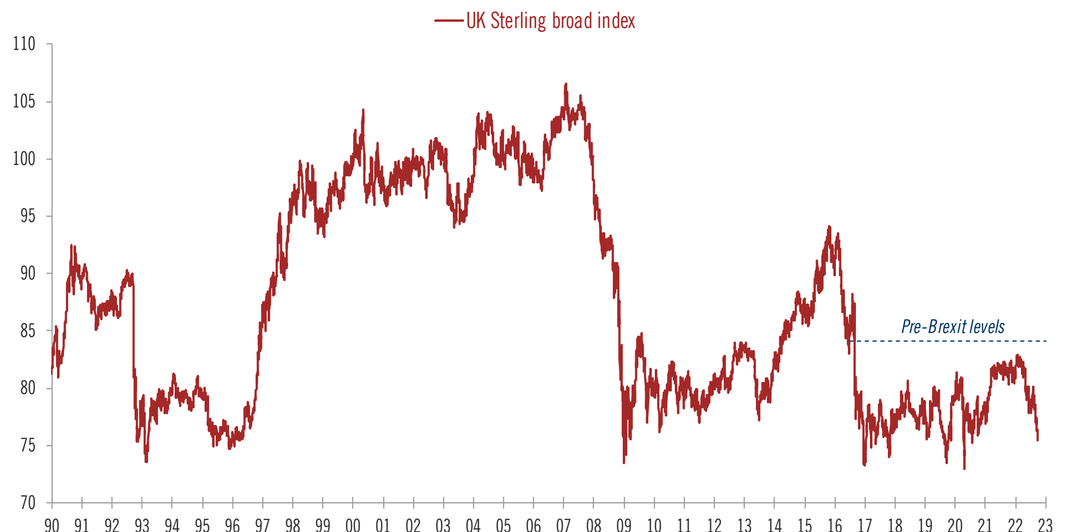
As such, we **expect UK gilt yields to move higher across the curve** and the yield curve to flatten further, with the 10-to-two-year slope moving further into negative territory (it stands at around – 30 bps as we type). Hence, we revise our **year-end forecast for the 10-year UK gilt yield from 2.8% to 4.2%**; we remain underweight UK gilts.

GBP to remain under pressure

The **UK's large current-account deficit (8% of GDP in Q1) is a key vulnerability for sterling**, which has already weakened considerably against the US dollar this year. The UK has increasingly relied on the 'kindness of strangers' to finance this deficit, which is structural in nature. The mini-Budget suggests that such reliance may increase further, raising concerns among investors and explaining why sterling is depreciating sharply despite a strong increase in the 10-year gilt yield. We have been cautious on sterling for some time as we view this cyclical currency as particularly vulnerable to a global slowdown, while it does have a very weak trade balance, unlike major commodity currencies.

While potentially overblown, the rising concerns about a balance of payments crisis suggest that **sterling should best be avoided in the short term**. It could take a very hawkish Bank of England to support sterling, but given already very high market expectations for the Bank's rate path in 2023, it may not be easy to beat the market and get back "ahead of the curve".

CHART 4: STERLING REACTED VERY NEGATIVELY TO SUDDEN LOOSENING OF BUDGET STANCE



Source: Pictet WM – CIO Office & Macro Research, Bloomberg Finance LP, 23 September 2022.

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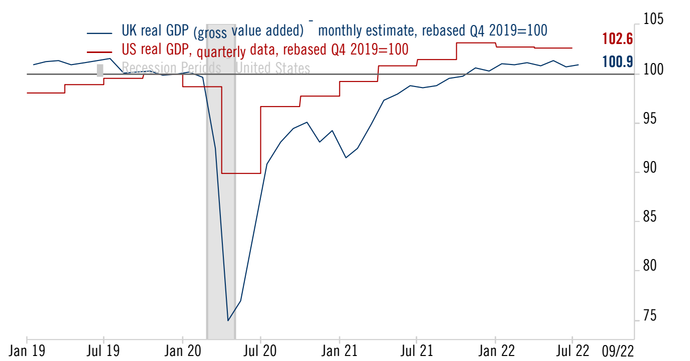
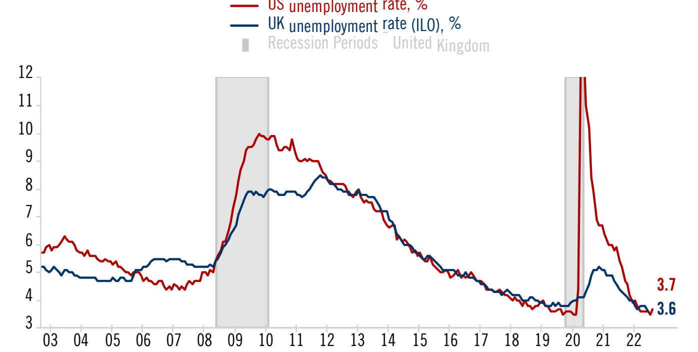
Charts: UK vs. US macro

US V. UK: GDP GROWTH, % Y-O-Y



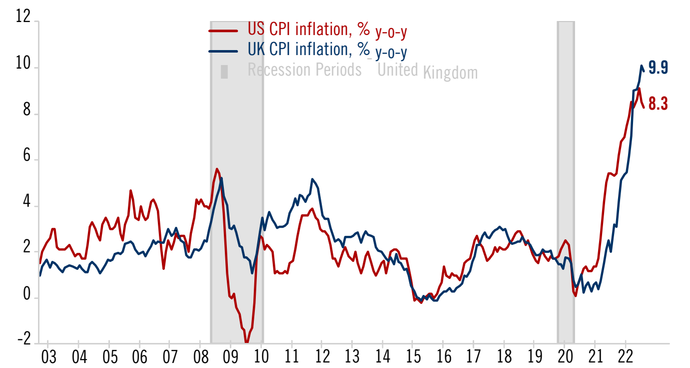
Source: PWM - AA&MR, Factset

US V. UK: UNEMPLOYMENT RATE, %



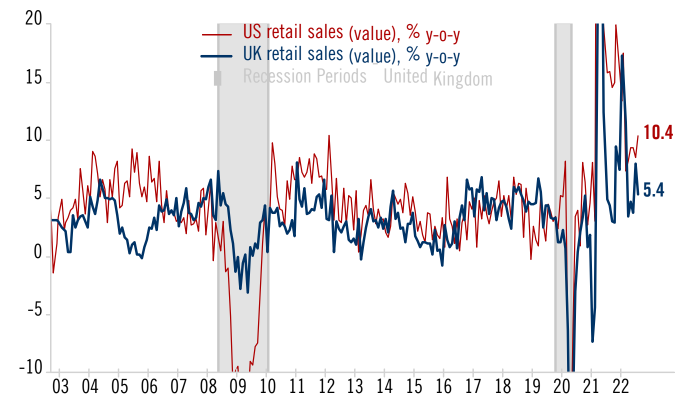
Source: PWM - AA&MR, Factset

US V. UK: CPI INFLATION, % Y-O-Y



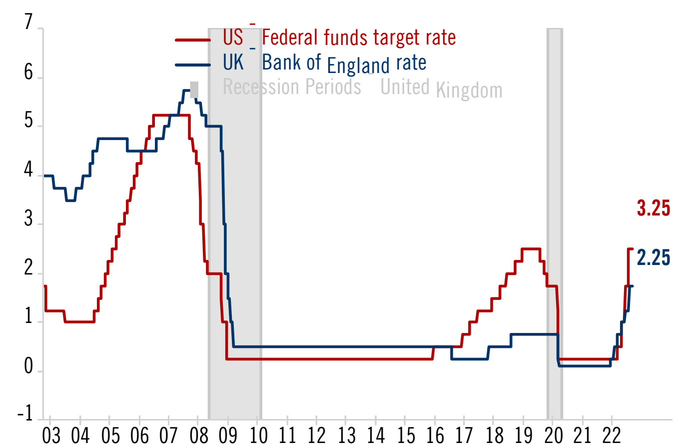
Source: PWM - AA&MR, Factset

US V. UK: RETAIL SALES, % Y-O-Y



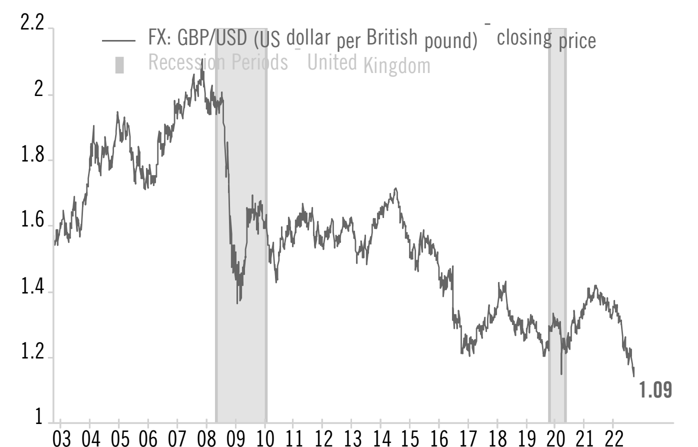
Source: PWM - AA&MR, Factset

US V. UK: BENCHMARK CENTRAL BANK RATE, %



Source: PWM - AA&MR, Factset

US V. UK: EXCHANGE RATE GBP/USD



(Note: closing price) Source: PWM - AA&MR, Factset

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