

InvestmentUpdate

28 October 2021

Autumn Budget 2021: A lot of moving parts

Despite some unanticipated giveaways, fiscal policy is tightening dramatically. Political confusion and economic uncertainty further cloud the outlook.

Politically, this was a very confusing Budget. A Chancellor, who recently told his party's conference that government borrowing was immoral, boasted to Parliament about record increases in government spending, which weren't actually record-breaking in any meaningful sense, before delivering passionate concluding words that emphasised the need to ratchet down spending at some point in the near future. Perhaps Prime Minister Boris Johnson decided the numbers, while Rishi Sunak wrote the speech.

Whether the rhetoric makes sense is usually neither here nor there to us. As investors, all we care about is whether the economic impact is likely to cause the UK economy to deviate from the path it was already on, and whether any specific policies will alter the outlook for financial assets. But political confusion does mean that we have less certainty that the policy projections set out this week won't be altered substantially in 2022 or 2023.

For now, to assess the impact of what we have been told, it's worth starting with an attempt to answer some preliminary questions about the UK economy. Because, undoubtedly, the recovery has entered a more challenging phase (as we set out at the global level in our [last quarter-end InvestmentUpdate](#)).

Is the recovery secure, and are there still long-term economic risks from the pandemic?

The Office for Budget Responsibility (OBR) now thinks UK GDP will be back to its pre-COVID level by the end of the

year, a very significant upgrade from the last forecast in March. But a faster near-term rebound doesn't necessarily mean a more complete medium-term recovery. Indeed the OBR estimates that growth will fall back to just 1.5% on average between 2024 and 2026. Also, it expects the pandemic to have left a 'scar' on the economy equivalent to a 2% permanent reduction in economic output relative to what it would otherwise have been. That said, in March the OBR thought this scar would be 3% (the OBR's revision is consistent with most other forecasters). And 2% would be the lowest scar from any modern recession.

This scarring comes from the productivity impact of lost business investment during the pandemic, as well as the effect of firms not making it through the last two years, with a permanent impact on the employability of some people who lost their job as a result. And, as an extension to this, there's the invested capital lost in some consumer services businesses that may never return to their pre-COVID paths of growth due to a permanent reconfiguration of the economy. For example, a recent Bank of England (BoE) survey of businesses suggests firms expect the average number of days per week spent working from home will increase from 0.5 before the pandemic to an expected 1.2 in the long term. This will have a permanent impact on commuter transport services, which accounted for roughly 3.5% of total spending before the pandemic, as well as other goods and services which rely on commuters.

As well as changes in the sectoral composition of the UK economy, a geographic shift seems likely too. This will also entail some economic impairment as a result. The recovery in mobility and footfall has been uneven: retail and recreational activity in Greater London are still 30% below pre-COVID levels, while they are well above them in some provincial towns. Halifax property data outside of London suggest a similar story. Since March 2020, house price growth was 18% lower in city centres compared with surrounding areas.

Still, despite the OBR's positive revision, the reality is that there remains huge uncertainty around the extent of any eventual scarring. This uncertainty is amplified by the shorter-term sharp deceleration of growth in the third quarter (somewhat sharper in the UK than many other major economies, despite having further still to rebound). Retail sales were lifted in September by panic-buying of petrol, but sales volumes (i.e. inflation adjusted) still fell for the fifth month in a row. Some of this sustained fall in retail revenue is due to us all starting to resume normal spending habits – which means more spending on consumer services not captured in retail sales. However, CHAPS card spending data continue to point to hospitality and excursions spending in particular coming in weaker than expected. Then there are the risks stemming from rising inflation, which the UK isn't alone in facing.

What are the risks of runaway inflation, and what is the outlook for monetary policy?

After a short pause in September, we expect UK inflation to pick up again in October as the 12% rise in the energy price cap takes effect. A perfect storm of factors, largely due to the ongoing pandemic-driven disruption of both demand and supply, is then likely to push CPI inflation above 4% by the end of the year and keep it at a similar rate through to spring 2022.

A wage-price spiral akin to the 1970s still seems very unlikely to us. Inflation is as much an institutional phenomenon as it is a monetary one, and the institutional environment is very different to the 1970s. There are few inflation-indexed wage contracts today, for example, while in the '70s the central bank didn't explicitly target inflation.

The major cause of global inflation is that the world is still spending an unusual amount on goods, because it is taking longer to start spending as much on services as it did before the pandemic. There are some new signs that these dislocations are starting to correct: service sector activity held up much better than expected in the latest business confidence (PMI) surveys: the UK service index rose from 55.4 to 58.0 in the survey covering early October. And supply chains are beginning to ease. Microchips have been behind the shortage of many goods, particularly cars. Supply is finally shifting to meet the demand pattern for these predominantly lower-tech chips (even cars run low-tech chips), now that the outsized demand for higher-tech chips for new laptops, phones, etc. is falling.

The underlying rate of wage growth is far from alarming. For all the anecdotes about labour shortages, our reading of the data is that they are concentrated in only four industries, which together account for a relatively small percentage of employment. Along with leisure and hospitality, the sectors with the highest levels of vacancies are also the ones that

had the most workers furloughed at the end of the summer. Now the furlough scheme has ended shortages should ease, as some companies will fold or downsize, freeing up previously furloughed labour for their more resilient peers in need of staff.

Also, aside from the heavily distorted index-linked gilt market, there's little evidence in consumer surveys that inflation expectations have become unanchored.

If the BoE hikes rates, it won't bring the demand for microchips back into balance with supply or convince people to stop buying new furniture and spend more money in the cinema. We think it would be a mistake if the Bank embarked on a marked tightening cycle in order to combat inflation, because we think the underlying causes are not something UK policy can influence. We are somewhat concerned therefore that Bank officials have not pushed back on the rapid change in market-based interest rate expectations, which now anticipate four to five rate hikes between November and the end of 2022, taking base rates to between 1 and 1.25%. In our opinion, this would be a significant monetary policy mistake that we do not expect the Bank to carry out. We think base rates back to 0.75% by the end of 2022 to be more realistic.

Don't forget about Brexit

The Chancellor glossed over the evidence presented to him by the OBR that trade with the EU was down sharply, consistent with its projection that reduced trade as a result of Brexit would reduce productivity by 4% compared to what it would otherwise have been. This means the impact on GDP is bigger than the 2% scarring expected from the pandemic. The elasticity of output from trade is huge, due to increased competition, more sharing of ideas across boundaries, greater cross-border investment, and being able to concentrate on what you do (relatively) best.

This chimes with research conducted by the UK Trade Policy Observatory, which

uses a technique we've harnessed in the past to measure the very large amount of lost business investment since the referendum. Compared with a counterfactual scenario where the UK remained in the EU, the Observatory found that UK exports to the EU are 14% lower and imports are down 25%. The BoE's Agents' survey and the PMIs also point to EU consumers pivoting away from UK suppliers. If professional services exports to the EU had grown in line with their non-EU equivalents – as was largely the case before the 2016 referendum – UK exports to the EU in these sectors would be around double their current levels.

Summing up the Treasury's new policy

Year-to-date borrowing has come in much, much lower than expected due to a faster recovery than previously expected. We are pleased that the Chancellor has decided to spend some of the savings made (borrowing over the first half of fiscal year 2021-2022 totalled £108.1 billion, £43.5 billion less than forecast by the OBR). We also welcome that some of the proceeds of better projected growth in future years have also been allocated today. But make no mistake, the government has chosen to save a substantial amount, and the UK economy still has to cope with a huge fiscal tightening for the remainder of the 2021-22 fiscal year and into 2022-23 as well.

Our preferred measure of fiscal 'drag' or 'thrust' is the change in a measure called the 'cyclically adjusted primary deficit'. This looks at government receipts minus expenditures adjusted for underlying economic conditions. The change in the deficit will be -7.5% in the current fiscal year (harsher than the -6.7% forecast in March), and -4.2% next year (albeit less stringent than the -5.4% previously expected). In other words, after taking into account the state of the economy, government activity will actually be a significant drag on output.

As such we think policy changes won't alter the likely path of growth over the

next two years. Fiscal drag is still likely to be harsher than that experienced in the Eurozone, due to ongoing disbursements from their recovery fund. UK fiscal drag is also likely to be harsher than that experienced in the US, depending on whether Congress passes spending bills still being debated.

We are concerned about such a fierce UK fiscal tightening in the context of the profound uncertainties and hawkish monetary policy discussed so far. Tightening prematurely could mean not only a slower recovery, but ultimately a less complete one too. The Treasury has already legislated for tax increases from April 2022.

If the economic recovery were to speed up and inflation to rise further, the BoE could quicken monetary tightening if needed. But if the economy turns out weaker, monetary policy cannot provide more support given interest rates are already so close to zero and quantitative easing only works when financial markets are in a state of pronounced stress – something that a simple loss of economic dynamism is unlikely to provoke. Fiscal policy is typically slow to change course, which is why we worry about embarking on such marked tightening today.

Are UK public finances sustainable?

The obvious counter to this position is that the Chancellor had no choice because the UK's finances were on an unsustainable path. As we set out [in March](#), we don't agree with that view. Clearly the deficit spending of last year can't continue forever, but with the second lowest debt-to-GDP ratio of the G7 nations, and record-low debt servicing costs despite the run-up in borrowing, the UK can afford to continue to run significant deficits. We took the time to explain this admittedly difficult to understand concept [last November](#), so please have a read if you are interested.

Empirically, the idea, repeated by the Chancellor on Wednesday, that more borrowing means higher interest rates is

not true – as the last 30 years makes plain. In short, while debt servicing costs remain a fraction of the 6% of GDP that the Chancellor believes is a red line, the government should concentrate on using fiscal policy to increase potential growth.

The best way to do that is to increase both public and private investment, which the current government is already doing. But only half of the government's capital spending envelope has been allocated, and we want to hear more about where this will be spent.

Sure, the sensitivity of public finances to interest rates has increased since the pandemic, but only a little. A one-percentage-point increase in gilt yields was previously expected to raise UK debt servicing costs by a little under 0.25%, now it's a little over 0.3% of GDP. That means the recent run-up in gilt yields does not really move the dial.

We do think fiscal policy should tighten meaningfully when the economic recovery is on a surer footing, especially as government balance sheets will be called upon to lend a bigger hand to combat future recessions now that monetary policy is more constrained. But with the UK economy still a normal-sized recession away from pre-pandemic levels, and with considerable uncertainty over its outlook, we don't think it should be today.

Combating climate change and other long-term issues

With COP26 focusing the world's attention on the UK, it was disappointing not to see more policy to combat climate change. The OBR estimates the transition to net zero will impose additional fiscal costs amounting to 2.2% of GDP by 2026/7. The Treasury appeared to ignore this.

Most developed market governments agree that it's paramount that we meet Paris Agreement targets to prevent global warming. Unfortunately, current policy makes it highly unlikely that the world will succeed. If governments begin to adjust policy today, transition

risks to economic output and inflation are likely to be low. If they kick the can down the road, they will need to impose a much sharper adjustment later, which would come with much greater transition risks to growth. For more, take a look at our COP26 primer [here](#).

The costs of adult and social care are likely to grow over the coming decades too (our report [Too poor to retire](#) detailed some aspects of this). Thanks to the new health and social care levy, taxes as a percent of GDP will rise to levels not seen since the 1940s. Contrary to what Mr Sunak said, the challenges of ageing populations and climate change meant taxes were on track to do so even before the pandemic, and it is difficult not to see yet higher taxes over the next decade.

Business related policies

Alcohol-duty reform has helped public company share prices, but retailers have more to worry about. There was less done on business rate reform, a looming higher corporation tax and a long-planned 6.6% increase in the minimum wage at a time when margins are already under pressure. Moreover, a 1% predicted reduction in the median earner's after-tax, after-inflation income over the next year and pitiful growth thereafter, according to the OBR.

The 'super deduction' from corporate tax bills for investment was extended, but the impact has sadly been mixed so far, with economic uncertainty likely holding back capital expenditure.

The relatively large fiscal tightening and risk of a monetary policy mistake make the globally oriented FTSE 100 Index more attractive relatively to the small and mid-cap indices, which have underperformed by an extraordinary 7% over the last five weeks, due to less protection from rising inflation and interest rates.

The larger-than-anticipated reduction in the issuance of government bonds has sent gilt yields lower. This should have been felt more acutely at shorter-maturities, but the fact that 10-year

yields fell further perhaps suggest that investors have been left more concerned about the UK's growth prospects longer-term. We expect a readjustment in market interest rate expectations to alleviate upward pressure on gilt yields too. Unusually, two-year gilt yields have moved 0.25% less than the historically very, very close relationship with the implied expectations for the BoE interest rate in two years' time. Because of this, we expect gilt yields to hold steady rather than fall back. Ten-year borrowing costs may face continued upward pressure if growth momentum improves again, but the reaction to the budget suggests concern.

Sterling wasn't much impacted by the Budget announcements. It hadn't moved significantly on recent changes in BoE interest rate expectations either. If it had, based on the past relationship sterling should have appreciated by 15% – so crazy had the change in expectations been. A readjustment of expectations to a more plausible path for the BoE would therefore not do much to the currency. On a long-term basis, the pound is still trading below the rate implied by economic fundamentals, and we would expect sterling to start rising again if we get another risk-on episode in investment markets more broadly (the pound is a 'cyclical' currency). There could also be a bump for the exchange rate if the troubling renegotiation of the Irish protocol concludes harmlessly.

Financial planning implications

There were few surprises in the Budget from a financial planning perspective, as many measures had been announced in advance, on top of the tax increases revealed in the Spring Budget.

The Chancellor has committed to reducing taxes by the end of this parliament, however, in the meantime most people may find that their taxes will grow over the coming years. This is mainly due to the compounding effect the five-year freeze on the various tax bands, allowances and thresholds will

have if taxable earnings and savings increase.

Health and Social Care Levy

The new UK-wide levy commences in April to fund investment in the NHS and social care. As a temporary measure it will be funded initially by a 1.25% increase in National Insurance Contributions (NICs) and dividend tax rate and a separate tax on earned income from 2023.

The levy will be paid by employed and self-employed individuals earning above the primary threshold and lower profits limit (£9,880 in 2022/23). Someone earning the median basic rate taxpayer's income of £24,100 in 2022/23 would be expected to pay an additional £140. Someone earning the median higher rate taxpayer's income of £67,100 would be expected to pay an additional £678.

From April 2023, a proportion of the money raised by the levy will go to those responsible for health and social care across all parts of the UK to fund the new social care cap of £86,000 (i.e. to pay for anything above that amount, which first has to be covered from a person's savings). We'll be writing more about the social care cap and its limitations in an *InvestmentUpdate* coming soon.

Income Tax

The personal allowance of £12,570 and the basic rate limit of £37,700 are frozen at current levels till April 2026. Basic rate, higher rate and additional rate income tax will remain at 20%, 40% and 45% respectively for 2022/23. The additional rate threshold remains at £150,000.

The Scottish Budget takes place on 9 December when we can expect to hear of any changes to the rates and bands for Scottish taxpayers. Of course, the Scottish rates of tax only apply to non-savings income. So Scots will continue to pay tax on savings and dividend income in line with the rest of the UK.

Capital Gains Tax

Despite recommendations from the Office of Tax Simplification to raise Capital Gains Tax (CGT) rates and reduce the annual exempt amount, both will remain unchanged. On an administrative point, from 27 October the deadline for residents to report and pay CGT after selling non-exempt UK residential property will increase from 30 days after the completion date to 60 days.

Individual Savings Account

The 2022/23 annual subscription limits for adult and junior ISAs remains at £20,000 and £9,000 respectively.

Pensions

Pensions were broadly untouched. The Finance Bill 2021-22 will increase the age at which most pension savers can access their pensions, from age 55 to 57, with effect from 6 April 2028. The pension lifetime allowance remains frozen at £1,073,100 until April 2026 with any excess usually liable to a tax rate of either 55% or 25% depending upon how the savings are accessed.

State Pension

As a temporary measure, the triple lock on the state pension will be suspended for the 2022/23 year to avoid a bumper increase of 8.3%. It will instead increase by 3.1%, this means the full New State Pension will increase from £179.60 to £185.15 per week and the full old basic State Pension will rise from £137.60 to £141.85 per week. The current State Pension age is 66, rising to 67 in 2028.

Inheritance Tax

This tax also remains unchanged, but financial planning will become ever more important for families wishing to pass on a legacy to younger generations, as the inheritance tax nil rate bands remain frozen until April 2026.

What next?

The Chancellor appears to be building a war chest in preparation for the next general election, currently scheduled to be held in May 2024. The question is: who will benefit from the boost in the chancellor's finances?

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