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Investment *View*

24 October 2022

The mini budget is mostly gone, but the scars remain

In a remarkable reversal, the government has now scrapped most of ex-Chancellor Kwasi Kwarteng's 'mini budget' a few short weeks from the day it was announced. It won't be possible to make a complete judgement on the budget about-face until we know more details (especially about the altered energy scheme and where any mooted spending cuts fall), but in the main it is reassuring.

The original 'mini budget' represented a large and unwarranted injection of demand into an economy already struggling with high inflation, leaving fiscal and monetary policy pulling in opposite directions. That's clearly no longer true to anything like the same extent, and the government's approach has completely changed. The UK no longer looks like a major outlier internationally on fiscal policy either, with most other European governments providing significant energy support, and UK markets have so far reacted positively to the news of the U-turn.

The borrowing required to fund the remaining measures would still leave fiscal policy 'looser' compared to the status quo pre-mini budget (see figure 1 below). The costs are about a third of the original package, but that may yet be offset by reduced spending. The new Chancellor, Jeremy Hunt, has mentioned the possibility of departmental spending cuts, without revealing any specifics.

The energy bill support scheme will exist in its current form only until April 2023 (rather than October 2024), from which point it will be altered in a way that reduces its cost to the government. Again, the details are yet to be decided. But Hunt mentioned better targeting of the most vulnerable and a greater focus on energy efficiency. Both of those features would be welcome in our view compared the current programme, which implicitly subsidises the heaviest energy consumers (for example wealthy households with multiple large homes) the most.

Wither interest rates?

The government's U-turns should reduce the pressure on the Bank of England (BoE) to increase interest rates further. Admittedly, the decision to reduce the generosity of the energy price cap from April is a complicating factor. It may slow the decline in headline inflation next year, depending on what happens to the current energy bill freeze - we'll have to wait until we know exactly how the scheme will be changed. But monetary policymakers were arguably even more concerned about the broader inflationary implications of much looser fiscal policy. (The BoE's Chief Economist had said after the 'mini budget' that "the fiscal easing ... will prompt a significant and necessary monetary policy response", for example.)

On balance, the fiscal U-turn should mean that the BoE tightens by less than it would otherwise have done, and this was reflected in market pricing of interest-rate expectations, which dropped sharply from their earlier peak.

Even so, it's worth reiterating that monetary tightening is probably far from over. Before the 'mini budget', the BoE was already signalling that it was prepared to keep increasing interest rates rapidly in the face of a long recession. Several BoE Monetary Policy Committee members voted to increase the pace of tightening at its last meeting, and policymakers had plenty of reasons to be concerned about the inflation outlook. The labour market is the tightest it has been in decades, partly because labour supply growth has been disappointingly weak recently. And there has been a concerning rise in firms and households' inflation expectations, which also pre-dates the fiscal policy drama. (Households' expectations of medium-term inflation, for example, climbed above 4% in YouGov/Citigroup's survey in August.) Overall, rates may now peak in the 4-5% range rather than the 5-6% that had seemed possible - but that still implies a further hit to the economy and sustained pressure on the housing market.

Some lasting scars

While most of the measures from the 'mini budget' will now never see the light of day, the fallout from the event could leave a lasting mark in a couple of other ways.

First, the episode has revealed previously underappreciated financial stability risks in the pensions industry, with many defined-benefit schemes becoming forced sellers of longer-dated UK government bonds (gilts) as yields spiked following the 'mini budget'.

The BoE's temporary intervention - buying gilts and eventually opening a new lending facility that distressed pension funds in need of cash could tap into - probably helped quell the forced selling. But there may still be pressure on pension schemes to change the way they operate further ahead. It's too early to tell precisely how this will play out, but one possibility worth being aware of is that we see a structural reduction in demand for long-dated gilts from pension funds further down the road.

Second, uncertainty about the UK political and policy outlook seems likely to remain very high for the foreseeable future, heightened by the subsequent (widely expected) resignation of Prime Minister Liz Truss. The largest tax cuts in nearly half a century have been announced and then scrapped in less than a month. The Conservatives currently trail Labour by more than 25 percentage points in the opinion polls, though there is no legal obligation for the next election to take place until January 2025.

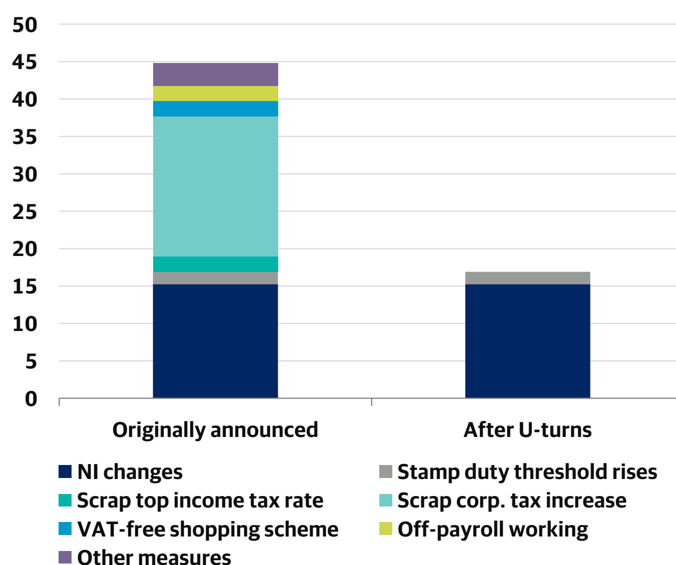
This uncertainty adds marginally to the headwinds for UK business investment, and therefore long-term growth. And the context is that private investment in the UK has already been weak for years, stagnating in real terms and trailing other major economies in the period of continuous instability over the UK's trade policy since 2016.

One silver lining is that UK investors with substantial overseas investments are protected somewhat from the weakness in the pound and generally have a wider field to search for better returns. This includes large British companies, which together make around 70-75% of their sales overseas.

Globally, we expect growing pressure on corporate profitability from rising interest rates, energy prices and wages. When financial conditions have tightened in the past, investors have typically rewarded companies with 'quality' attributes, according to analysis by Goldman Sachs. This is why we continue to favour defensive companies which score highly on these attributes.

Figure 1 shows the estimated impact on borrowing in five years' time of the originally announced measures - and the few that are left after Chancellor Hunt wielded the axe.

Treasury's estimates of extra borrowing in 2026/7 from 'mini budget' measures (£bn)



Source: UK Treasury, Rathbones

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