RATHBONES

AUTUMN STATEMENT

GIVE WITH ONE HAND, TAKE WITH THE OTHER

NOVEMBER 2023

CONTEXT IS EVERYTHING WHEN IT COMES TO DRAWING OUT THE INVESTMENT IMPLICATIONS FROM THE POLITICAL THEATRE OF THE AUTUMN STATEMENT, AND THERE ARE THREE PIECES OF CONTEXT PARTICULARLY WORTH HIGHLIGHTING THIS TIME AROUND.

First, previous decisions and the constraints the government faces mean that fiscal policy is not being loosened significantly. Yes, there are some headline-grabbing tax cuts – but they'll be offset by de facto increases elsewhere. Second, the UK economy is currently entering a downturn accompanied by falling inflation. The former is mainly a consequence of past increases in interest rates, while the latter has been helped by easing global price levels, particularly for energy. The measures announced today won't fundamentally alter that trajectory. Third, a general election looms next year and a change in government currently looks the most likely outcome. Although radical change in economic policy does not appear to be on the cards, this does mean that some of the specific measures announced this week may have a shorter-than-usual shelf life. This may explain why the government has committed to major departmental spending cuts that appear difficult to achieve.

While that mostly sounds quite downbeat, there are some potential silver linings for investors. One is the appeal of UK government bonds (gilts) against an economic backdrop of weakening growth and inflation plus relatively restrained fiscal policy. Government bonds tend to rise in price during recession and sustained stock market falls as investors flock to the security of a fixed return from the safest of issuers. Central banks usually cut interest rates during recessions to mitigate the economic fallout. Historically, government bonds maturing in 10 years or more perform well in the months ahead of such decisions.

Tax-cutting in name only

Among his 110 measures, Chancellor Jeremy Hunt placed the emphasis on various tax cuts: a two percentage point cut to the main rate of National Insurance (NI) to 10%; abolishing 'Class 2' NI for self-employed people and cutting 'Class 4' NI (for self-employed earnings between £12,570 and £50,270) by one percentage point to 8%; and making the 'full expensing' of business's capital investment (effectively reducing corporation tax) permanent. The Chancellor also committed to the triple-lock pension, which will be increased by 8.5%, taking the New State Pension to £221 a week. These changes affect all parts of the UK.

Yet what the Chancellor is giving with one hand is being taken away with the other. The ongoing freeze in income tax and NI thresholds (in place throughout the period of high inflation since 2021 and extended again by the Chancellor today) is an effective tax increase, and a far larger one than the NI cut. An estimated three million additional people will start to pay the higher rate of income tax as a result of the freeze. This so-called 'fiscal drag' means that the effective tax rate paid on all wages and salaries (both from income tax and national insurance contributions) is on course to increase from 38.6% in this fiscal year to 44% in five years' time according to the independent Office for Budget Responsibility (OBR). The OBR also forecasts that overall taxes as a share of GDP will rise, reaching the highest level since before their records began in 1948.

The Chancellor also set a number of measures to encourage investment and getting people back into the work force and reforming the process for planning applications for building and infrastructure. They also extended the Venture Capital Trust and Enterprise Investment Scheme (which provide tax breaks for investing in smaller UK companies) to 2035.

However, the OBR estimates that all these measures will make little difference to the size of the UK economy in five years' time. While tax changes aimed at boosting investment over the long-run such as permanent 'full expensing' are very welcome, the reality is that their ability to boost the economy can take years to be felt.

Economy struggling, inflation falling

The backdrop to the Autumn Statement is that the economy is struggling, while inflation continues to fall – in both cases largely for reasons that don't have much to do with fiscal policy.

The UK economy didn't grow at all in the third quarter of this year, and things appear to have worsened since. Recent increases in interest rates and the prior squeeze on real wages are clearly now taking a toll on the UK consumer. For

The value of investments and the income generated by them can go down as well as up.

example, retail sales fell by 0.3% in October compared to the previous month. Sales volumes are now at their lowest level since February 2021 when the UK economy was under COVID-19 lockdown restrictions. Meanwhile, house prices have fallen by around 4% since the middle of last year with much higher mortgage rates biting. Mortgage arrears have risen to the highest rate in seven years, and about 1.5 million more households will need to refinance at higher rates between now and the end of next year.

The Bank of England forecasts that UK growth will flatline in the near term and remain "well below historical averages in the medium term". Similarly, the OBR today downgraded its growth forecasts for 2024 and 2025. In our view, the economy is on the cusp of recession.

On a more positive note, the decline in inflation is now well underway and looks set to continue. UK headline inflation fell to 4.6% in October, down from 6.7% in September and below market expectations. The biggest single driver was prior increases in energy bills dropping out of the annual comparison – aided by successful Europe-wide efforts to get by without Russian gas. But this wasn't the whole story. Core inflation (which strips out the volatile energy and food components) also fell more than expected, from 6.1% to 5.7%. That reflected cooling domestic price pressures (most evident in the services sector), as higher interest rates slow the economy. The continued healing of global supply chains after the disruption of the pandemic has also made a difference.

Inflation should continue to ease, and it could be close to the Bank of England's 2% target again by the second quarter of next year. Growth in producers' prices (the prices paid by wholesalers at the factory gate) in the goods and food sectors has collapsed recently, pointing to further falls in consumer price inflation in those categories soon. And domestic inflationary pressure in the services sector should continue to fade, with the labour market loosening and early evidence that wage growth is falling.

Shadow of the election looms

With January 2025 the latest possible date for the next general election, and the Prime Minister unlikely to risk campaigning over the Christmas period, we look set for a 2024 election. A general election in Autumn 2024 would provide the government with maximum time to meet the five priorities the Prime Minister outlined at the beginning of this year and improve in the polls before going to the electorate.

Recent by-election results and the scale of Labour's current lead in the polls suggest that the chances of the Conservatives turning the tide are slim. The Conservatives suffered two defeats in October by-elections, as Labour overturned large majorities in Mid Bedfordshire and Tamworth. YouGov's latest nationwide polls show Labour with 44% of the vote, compared to the Conservatives' 21%, figures that have remained fairly consistent over the past year.
Of course, public opinion can shift – as we saw ahead of the 2017 election when Theresa May squandered a polling advantage that had briefly exceeded 20 points – and opinion polls can mislead. Yet the required swing in sentiment or polling error would be large by past standards. One academic study of data since the Second World War shows that the correlation between Conservative polling support as much as a year ahead of elections and their eventual vote share is very high.

Unlike the 2019 contest between Boris Johnson and Jeremy Corbyn, the forthcoming election won't offer voters the choice between two dramatically different economic models. The shape of Brexit is no longer on the line and, under Keir Starmer, the Labour Party has abandoned much of his predecessor's economic radicalism (now describing itself as "proudly pro-business"). Meanwhile, both major parties have affirmed their commitment to strict fiscal rules since last year's 'mini-budget' fiasco. And they have almost identical plans to increase housebuilding.

However, there are still some contrasts between the parties' likely platforms. A notable area of difference is the environment. In 2021, Labour announced their Green Prosperity Plan, including a pledge to invest £28bn a year on green projects – their single largest spending commitment. Shadow Chancellor Rachel Reeves has since rowed back on this figure, citing the constraints of her proposed fiscal rules and saying instead that they would gradually "ramp up" spending to this number. Yet even so, the Labour Party looks likely to offer a more interventionist stance on environmental policy than the Conservatives. Rishi Sunak recently announced a softening of the government's net zero policy, including delaying the ban on new diesel and petrol vehicles by five years to 2035 and enhanced scrutiny on the costs of proposed environmental measures. Labour also appears more committed to activist industrial policy, but this far ahead of the election we're still light on detail.

Investment implications

Taking a step back, we have a weakening UK economy with falling inflation, fiscal policy relatively restrained and dramatic policy change unlikely at the election. That backdrop looks favourable for UK government bonds. Although the Bank of England is currently sticking to its 'higher for longer' message on interest rates, that could change quickly next year with inflation back near its target and the economy in recession. Gilts have historically performed well ahead of the first interest rate cut in a cycle. As for the UK economy and markets overall, there isn't much to get excited about from this year's autumn statement.

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ADDITIONAL INFORMATION

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