RATHBONES

HAPPINESS IS RELATIVE

REVIEW OF THE WEEK
27 NOVEMBER 2023

AFTER A MISERABLE YEAR FOR LIVING STANDARDS, BRITS ARE FEELING MUCH BETTER ABOUT THEIR LIVES AND THEIR FUTURES. BUT HOW MUCH WILL THAT MOVE THE DIAL FOR RETAIL SPENDING AND ECONOMIC GROWTH?

UK consumers have been miserable for a long time. But this year they've become significantly less miserable, according to the UK consumer confidence survey. At -24, it's still below the long-run average of roughly -10. It had plummeted to an all-time low of almost -50 in 2022! So Brits are much jollier as 2023 winds down.

However, this is quite confusing. Was 2022 significantly worse than the Global Financial Crisis? More grinding than the recession of the early 1990s? More shocking than Black Monday 1987? According to the survey, yes. At first, that doesn't really pass the sniff test. Last year inflation raced ahead, energy prices soared and the cost-of-living squeeze was harsh, even in the context of the UK's near unique 16-year stagnation of inflation-adjusted compensation per employee. Yet wages were rising and recession was avoided. Maybe life really is just a relative game. In 2022, the volume of retail sales dropped by 6.8%; so far this year they've remained flat. Inflation has slowly dropped back from over 11% to under 5% and wage growth has actually accelerated. Perhaps people feel that they are no longer going backwards at such a great speed of knots.

This feeling may also extend to mortgage rates, which fell back considerably in early 2023. According to the Bank of England, the average two-year fixed interest rate on a home with a 25% deposit dropped back to around 4.5% in April. In late 2022, the rate had soared to 6.0%. As more households came to refinance with each passing month, the rate they got was substantially better than they feared. While still eye-wateringly higher than the likely rate of their existing mortgage, it was no doubt a welcome reprieve from what they had expected only a few months earlier. Over the summer and into the autumn, the average mortgage rate moved sharply higher again in line with **a big shift in US and UK government bond yields**. However, as expectations of further central bank rate rises has ebbed, mortgage costs have started to drop back once again.

In short, stagnation feels infinitely better than reverse.

That said, the previously strong, predictive relationship between consumer confidence surveys and consumer spending has completely broken down since the pandemic – in most countries, not just the UK. Black Friday shopping is in full swing, so we will soon see whether Brits have decided to splurge more than expected.

While we think UK smaller companies are extremely undervalued compared with how they normally trade, we're still hesitant to believe that the UK is entering a renaissance. Despite moderating inflation and falls in mortgage rates for some buyers, there are still hefty increases to mortgage payments for 1.5 million households that are refinancing in the coming year, as well as a large and growing fiscal drag caused by higher tax bills.

Give and Take

Chancellor Jeremy Hunt did a bit of juggling at last week's Autumn Statement. He delivered tax breaks for households and businesses, increased the state pension and benefits, and avoided increasing debt. Yet his reasoning for doing so – that halving inflation created the headroom – **also shows why it's all a bit of a wash .**

As **we noted last week**, the combination of high inflation and high nominal GDP growth (i.e. not reduced to account for inflation), allied with frozen income tax thresholds, has swelled the government's coffers immensely. The benefit of the two-percentage-point cut in the rate of National Insurance will, in the round, be largely offset by more people paying higher taxes as their wages increase because the tax band thresholds are stagnant and inflation continues to rise by more than double the 2% target.

A stark illustration of the expansion of the household tax burden can be shown by looking at the real (inflation-adjusted) changes in the thresholds. Back in 2010 when the Additional Rate of Tax was introduced, it kicked in at 50% for all income over £150,000. Because of inflation, earning £150,000 13 years ago is the equivalent of £221,000 today. Today, the Additional Rate is applied on earnings over £125,141 (at 45% in England, Wales and Northern Ireland and 47% in Scotland). To convert this in the other direction, it would be like the UK levying its highest rate of income tax on people earning £85,000 in 2010. Not exactly the uber rich.

And this burden will only get worse as inflation and wages rise. The Chancellor has frozen all tax band thresholds for another five years. Obviously, there's an election between now and then, so he and the government may not be around to implement this policy. But long-term fiscal plans have been balanced using these assumptions, meaning there will be pressure on any successive government to maintain them to show fiscal prudence.

Many people despise taxes, but most will be happy to endure them as long as they see quality services in return. Good schools, handsome roads, broad care for the infirm, impoverished and elderly. Unfortunately, surveys suggest most people don't hold Britain's public services in high regard today. And the ability to improve public services is hamstrung by inflation rapidly outpacing public sector spending increases. As the general price level rises, the cost of providing services increases, so the real value the government can get from a pound of spending or investment falls. The Chancellor has announced a productivity drive for Whitehall, which is laudable, but it is also extremely unlikely to make up the difference.

One very helpful change to the tax code was making permanent the 'full expensing' of a business's qualifying capital investments. This means that when a company buys a new factory, production line or new software, it can report the transaction as an expense in its accounts in the first year. That reduces its taxable profits by the full sum of the investment, effectively getting a 25% discount (which is the corporation tax rate). Few advanced nations are this generous and this move should encourage greater business investment in the UK – something that has been severely lagging in the past decade. The government hopes it will create an extra £20 billion of investment that could help to kickstart the UK's ailing productivity growth. The Institute for Fiscal Studies estimates the policy will cost between £1bn and £3bn a year (rising in line with inflation) for as long as it remains in the tax code.

The Chancellor also set a number of other measures to encourage investment, get people back into the work force, and reducing the time to get critical infrastructure projects approved. Increasing the number of people who can find a job and contribute to the economy and improving our infrastructure should vastly improve society, people's lives and our nation's output. The Venture Capital Trust and Enterprise Investment Scheme (which provide tax breaks for investing in smaller UK companies) were extended to 2035, which retains strong tax incentives for investing in UK small companies and start-ups.

Anything that can encourages investment in the UK, its people and its businesses should help forge a brighter future.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.