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iFlow

MACRO MORNING BRIEFING

October 30, 2024

Don't Mention Austerity

Labour adopts "kitchen-sink" approach to first budget

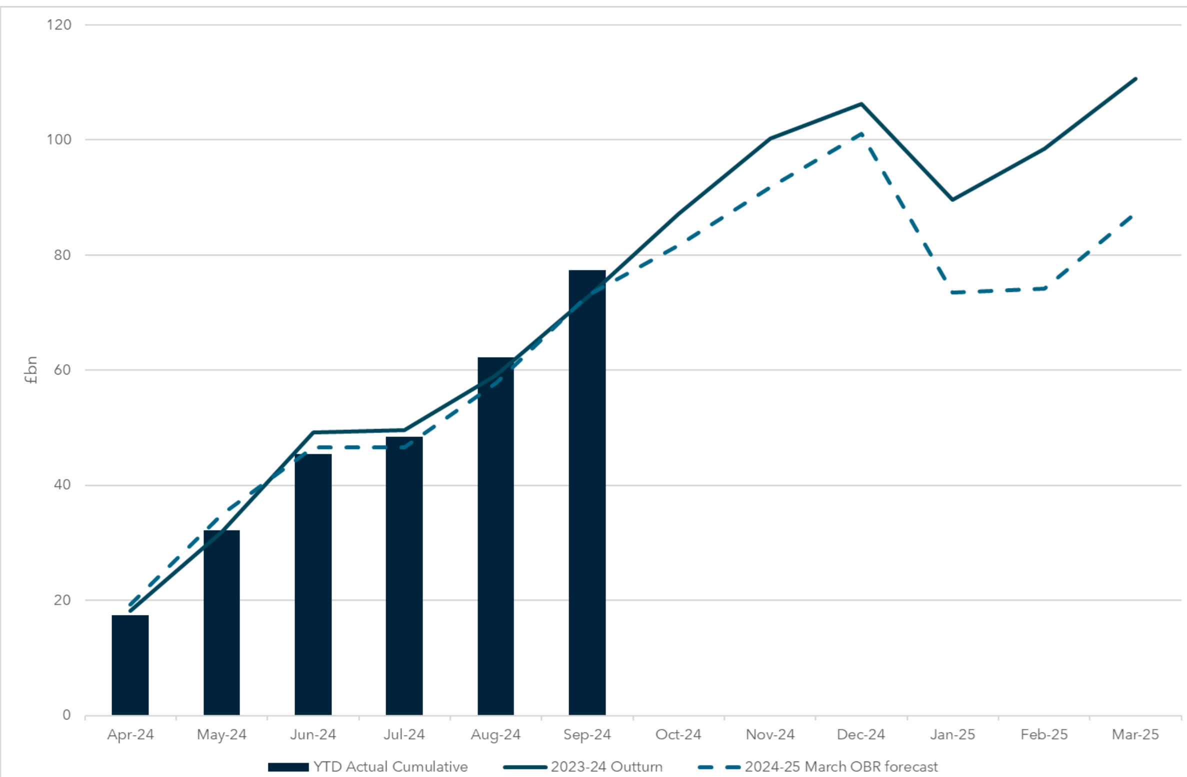
- £40bn fiscal hole requires difficult decisions
- Fiscal rule adjustments and falling inflation to provide borrowing space
- iFlow indicates strong sales of gilts in September

Investing for growth the priority, lest stagflation fester

UK Chancellor Rachel Reeves will announce the first budget designed by the Labour Party in over 14 years later today. The run-up to the event itself has been a rather difficult lesson for the new government in communications and expectations management. The Chancellor and Prime Minister have warned about the tough decisions up ahead regarding taxation and public services, but the hope is that a “kitchen-sink” approach will mean that the lowest possible base has been established and the next four years can only see improvements. Although expectations have been heavily managed, the FX and gilt markets are probably going to give the government enough benefit of doubt. Besides, next week’s events will weigh heavily on overall market positioning and both the pound and UK gilts might yet benefit from secondary haven status. Repairing the UK’s public finances will probably take more than one budgetary cycle, but the stronger the complementary focus on growth and productivity, the less painful the process will be. Structural aspects of the gilt market and the prospect of lower interest rates will give the government limited room, but it must be used as wisely and precisely as possible.

The government has repeatedly attributed the pain to its poor inheritance, but we do not expect this argument to have a long lifespan. However, it is true that borrowing is already off-course for the current fiscal year (Exhibit #1) so the marginal impact from additional borrowing will be less significant compared to the gyrations during the mini-budget crisis of 2022. There will be sufficient scrutiny from the Office for Budget Responsibility (OBR) to buttress credibility. This is crucial given revisions to the government's own budget rules are expected with the intent of increasing borrowing limits. Such adjustments have already been well-flagged so the gilt market will show tolerance for a significant nominal lift in issuance. Also of focus in a monetary policy context – indirectly – is the prospect of adjusting debt accounting of the indemnification of losses suffered by the Bank of England in its Asset Purchase Facility when selling gilts. This has long been flagged as a source of excessive fiscal adjustment independent to the UK's fundamentals and an outlier amongst developed market peers. As yields have fallen for gilts in any case, the risk of large losses is no longer as high, but the issue itself could have affected the Bank of England's quantitative tightening programme and may impact policy transmission.

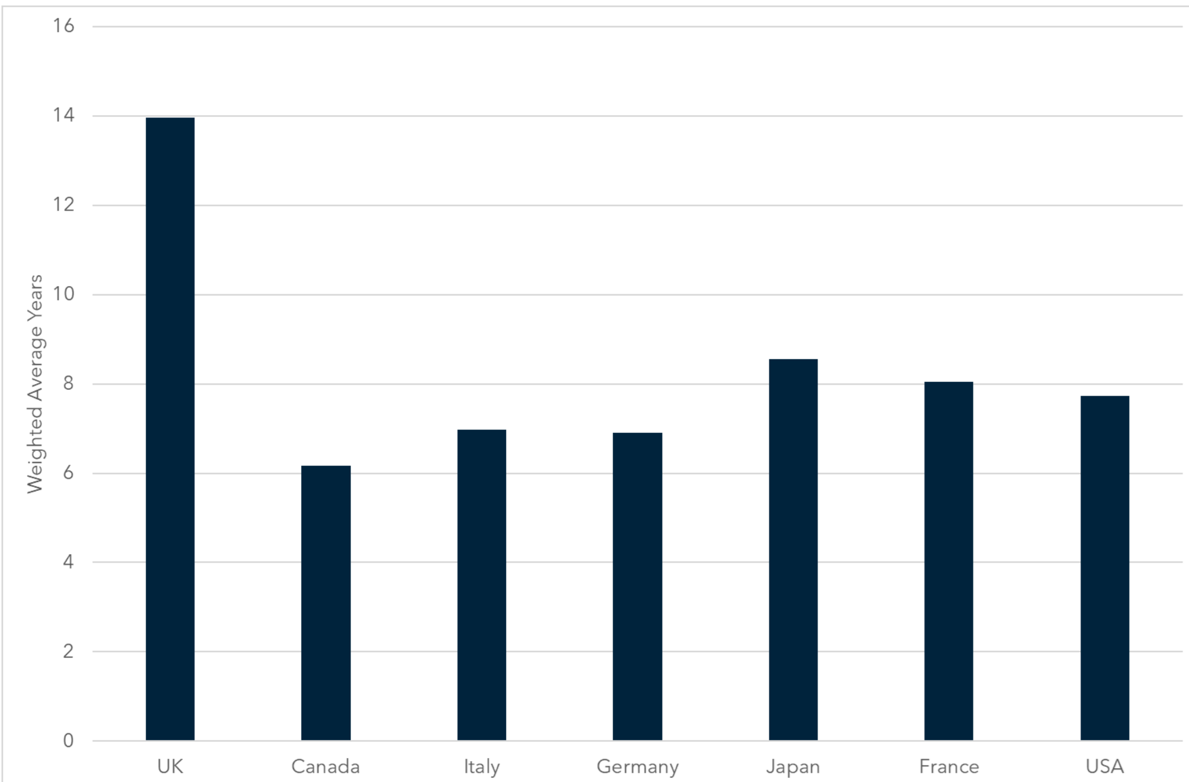
Exhibit #1: UK Net Borrowing vs. 2023 and Plan



Source: Office for Budget Responsibility, BNY

September's below-target inflation figures have also led to a November rate cut as the market's central scenario. Despite several false starts, in Europe at least, preference for duration is continuing to improve and the government can also find some headroom in debt servicing costs, not least due to the fact that the share of inflation-linked securities in gilts is materially higher than peers. Even so, relying on optimistic debt servicing scenarios is another aspect of issuance where market tolerance is also not unlimited. Nonetheless, given the “no-landing” narrative in the US is far stronger and the election results could lead to fiscal and inflation outcomes considered unfavourable for the US Treasury market, we continue to see prospects of the gilt market finding tactical favour amongst global government debt portfolios. The weighted average maturity of gilts is still the only government bond market in the G7 which remains in the double digits (Exhibit #2), and despite a bumpy start for Sir Keir Starmer’s first government, the market will view the UK’s political situation as more stable than peers in Europe and beyond for the next 4- to 5-year global electoral cycle. Policy continuity in the UK has been sorely lacking in recent years and the removal of this discount should continue to support demand at the margins, on top of the broader interest rate environment.

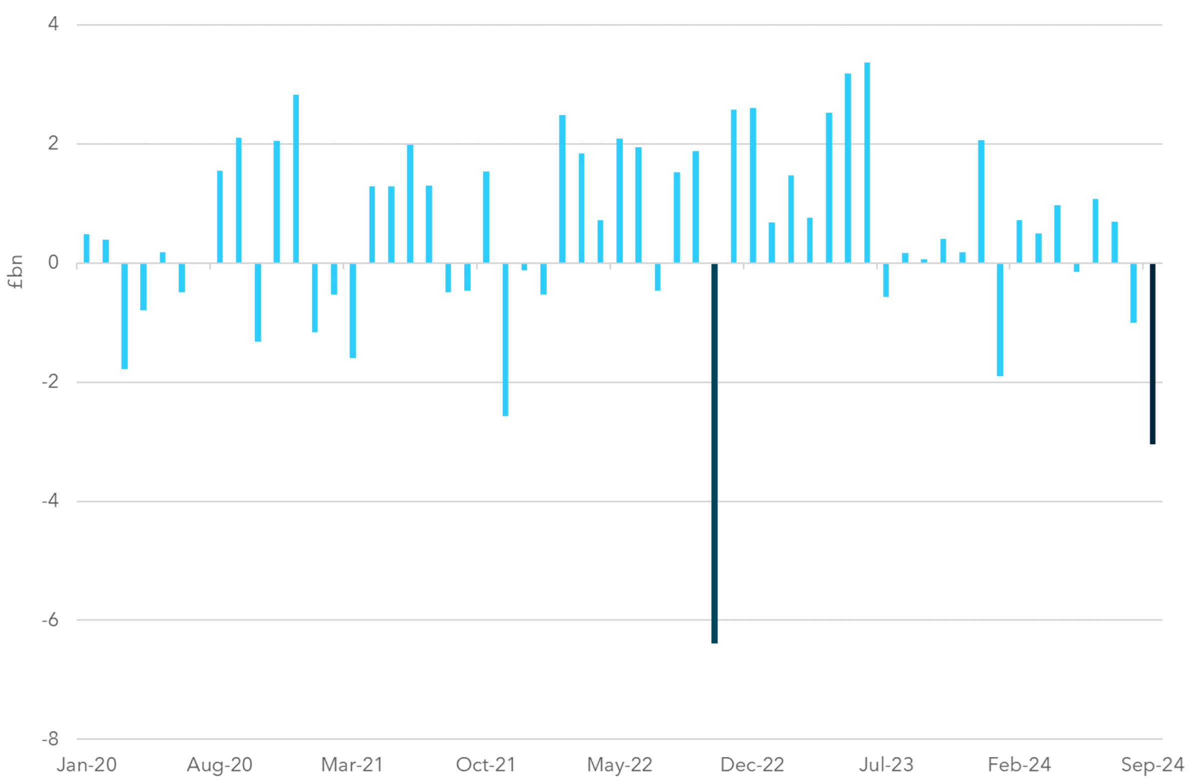
Exhibit #2: G7 Government Debt Average Maturities



Source: Bloomberg, BNY

European bond markets this year have shown repeated sensitivity to positioning and the gilt market is also not immune to such shocks. For example, we highlighted earlier this year that one of the reasons behind the very strong reaction to political developments in France were the strong purchases of French government bonds (OATs) from late 2023 onwards. The OAT market was far more liquid and provided a yield boost compared to bunds, but this meant that any sudden unwinding would have been amplified. In contrast, iFlow indicates that gilts face the opposite situation: perhaps due to the relatively sombre guidance for which the government was criticised in some quarters, gilt outflows in August and September were quite severe – with selling in the latter the strongest since the mini-budget liquidation seen in October 2022 (Exhibit #3), though cumulative outflows from our custody clients were still only half the levels of that month. Strong recovery took place from mid-October onwards, but the bottom line is that the market is very much underpositioned in gilts, even considering the larger-than-expected fiscal gap. When the revised figure of around £40bn was released in mid-October, the gilt market did not react adversely, suggesting investors remained confident regarding absorption of additional issuance, if required.

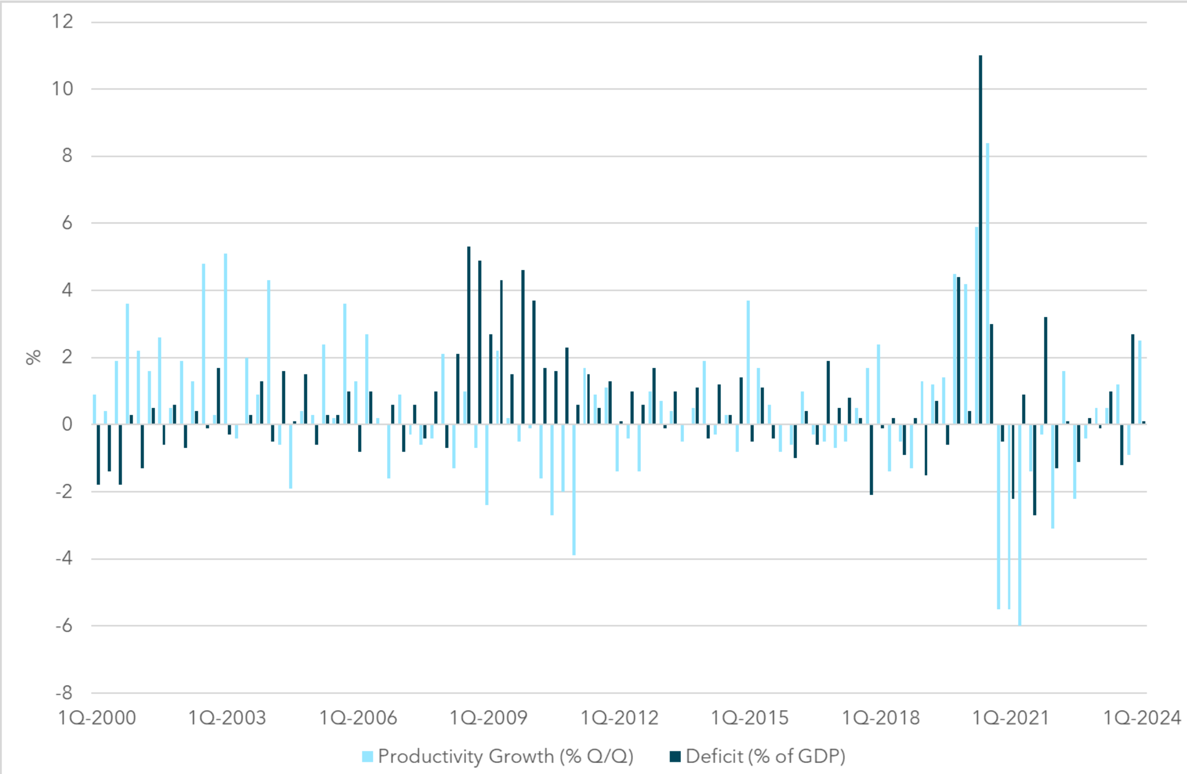
Exhibit #3: iFlow UK Gilt Transactions, Monthly



Source: BNY

In a recent OBR report on debt sustainability, the role of productivity was highlighted as essential in determining whether gross liabilities grow in a parabolic manner or stabilise below 100% of GDP. As such, bond markets will not be averse to near-term borrowing increases so long as there is a gradual emphasis towards public investment, which can serve to “crowd in” private investment through fiscal and regulatory reforms. Meanwhile, it remains to be seen whether the OBR shares the IMF’s more optimistic growth outlook for the UK. Exhibit #4 shows that while the first and second terms of the Blair administration at the turn of the century generated strong productivity growth which helped reduce the deficit, there has been a tenuous relationship between the two. Periods of “austerity” did not boost growth or productivity in any manner, and there is consensus in the country that a new approach is needed. Bond markets will likely provide sufficient leeway for now, but patience is in limited supply amid stretched fiscal positions globally. There will be no more fiscal kitchen sink to throw in in 2025.

Exhibit #4: UK Productivity vs. Deficits



Source: Bloomberg, BNY

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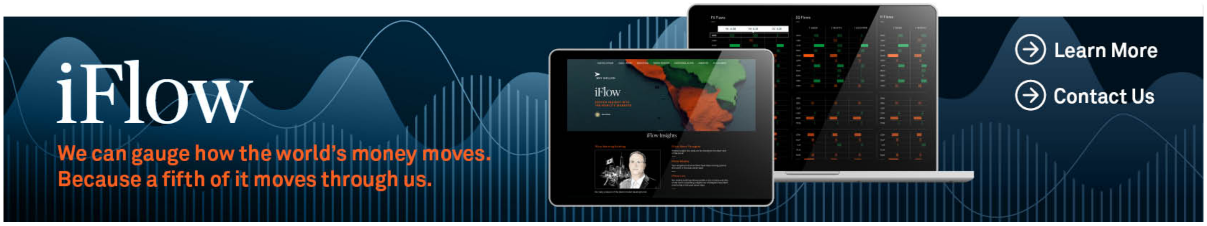

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