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Elston Insights

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Britannia: unchained or unhinged?

- Mini-budget's fiscal restructuring sends the pound sliding
- BoE announces emergency debt purchases amid market turmoil
- Do any UK equities stand to benefit?

Mini-budget triggers maxi-shock

The first mini-budget announced under Britain's new leadership set out the stall for "Trussonomics". As per their 2012 manifesto, Britannia Unchained, Liz Truss and Chancellor of the Exchequer Kwasi Kwarteng stated the case for prioritising growth over debt reduction, in one fell swoop banishing the age of austerity. While an exciting prospect in times of plenty, against a backdrop of soaring inflation, rising rates and monetary tightening, this seems to be too much, too late. The mini-budget triggered a maxi-shock for gilts and Sterling as the government essentially took a gamble with the UK's financial credibility.

By failing to publish figures that show whether and how the books can be balanced (due on 23rd November) after this unfunded tax cut, the market is left to judge whether their plan is viable. The surge in gilt yields and Sterling's nosedive suggest that the market views this policy as carrying more risk than reward. Indeed gilt yields rose so sharply that the Bank of England was prompted yesterday to intervene and buy up tranches of long-dated government debt in an effort to reassure investors and underpin orderly market function.

How does this affect UK equities?

While the attempt to unleash growth and productivity is positive for some UK companies in terms of their tax perspective, ultimately the corollary of a very weak pound favours exporters (stronger dollar, cheaper manufacturing costs), and penalizes those that rely heavily on imported goods.

Depending on managers or advisers' views on where the UK economy goes from here, there are a variety of ways to access UK equity exposure to reflect differing outlooks.

UK Large Caps: UK large caps have a high proportion of overseas earnings so funds benchmarked to the FTSE 100 can show relative strength in the face of a weakening pound

UK Mid Caps: UK mid-cap companies offer a clearer reflection of the domestic market. If the fiscal stimulus does indeed translate to a higher economic growth rate, then mid-caps have the potential to benefit. If sterling's slide leads to higher inflation and a deeper recession, mid-caps would be negatively affected.

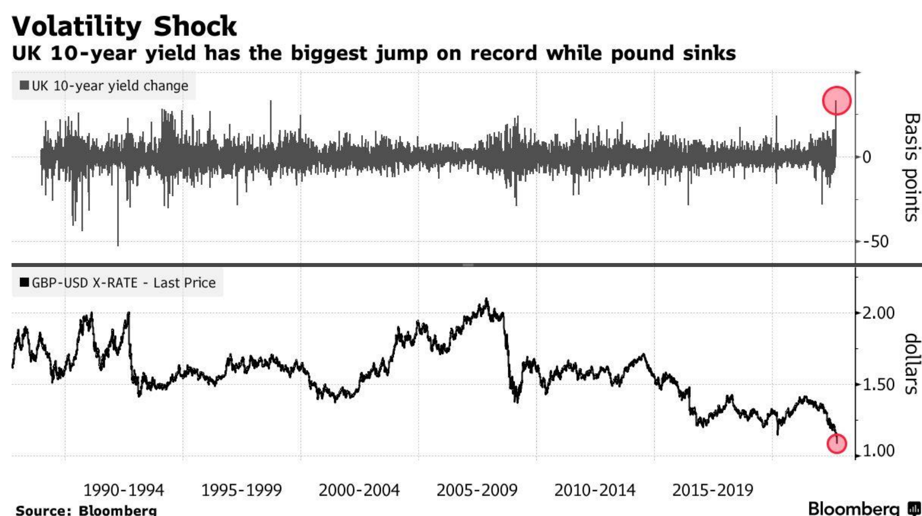
UK Small Caps: Ironically, the focus on unleashing growth may not in fact help "Growth-style" companies in the near-term. While UK small caps are domestically-oriented, their Growth-factor bias means that they exhibit "longer duration". In other words, they are more sensitive to rising discount rates (inflation and interest rates) by which future earnings are valued.

UK Equity Income: UK equities that generate an income tend to exhibit biases towards both Yield- and Value-factors and are therefore typically more resilient when the going gets tough. Value shares tend to be companies with a focus on reliable, recurring, near-term earnings. For advisers wanting a more defensive approach the yield-bias makes more sense.

Ironically, the £45bn planned tax cuts over 5 years on top of the £200bn price-dependent energy support package are material but nonetheless below the £300bn COVID support package in terms of scale.

This dramatic policy change of the mini-budget was poorly communicated and poorly timed against a bleak economic backdrop. Far larger £300bn debt creation that was unleashed to fight COVID was clearly communicated and carefully co-ordinated with the Bank of England, the gilts market took that in their stride. This shows it's not just about the numbers but as much about credibility and trust.

Fig.1. Sterling volatility shock



This chart shows the spike in UK Gilt yield volatility, and the decline in the value of Sterling, relative to the Dollar as the market adjusts to this unfunded fiscal event.

Summary

Managers and investors have the ability to target specific exposures within the broader UK equity space, depending on their view. Markets are still digesting the impact from this fiscal restructuring. Looking back in five years, we can judge if this was a bold stroke of genius, or a reckless policy error. The initial indicators suggest the latter.

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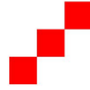

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