Elston

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Elston Insights

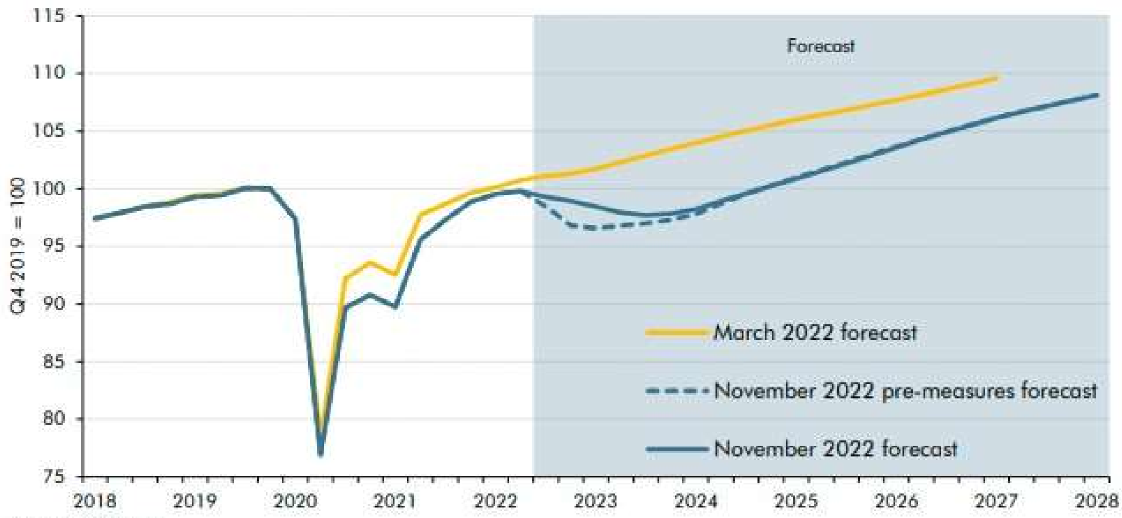
The Autumn Statement and what it means for outlook

- Economic headwinds for the UK are considerable
- The US is likely to recover faster than the UK and EU
- Advisers should consider globally diversified approach

The Office for Budget Responsibility's (OBR) accompanying report for the Chancellor's Autumn Statement makes gloomy reading.

As outlined in our July 2022 Insight: *The Risk to Growth*, the prospects for global and UK economic growth have deteriorated, relative to the start of the year, prior to the Ukraine war.

Chart 1: Real GDP

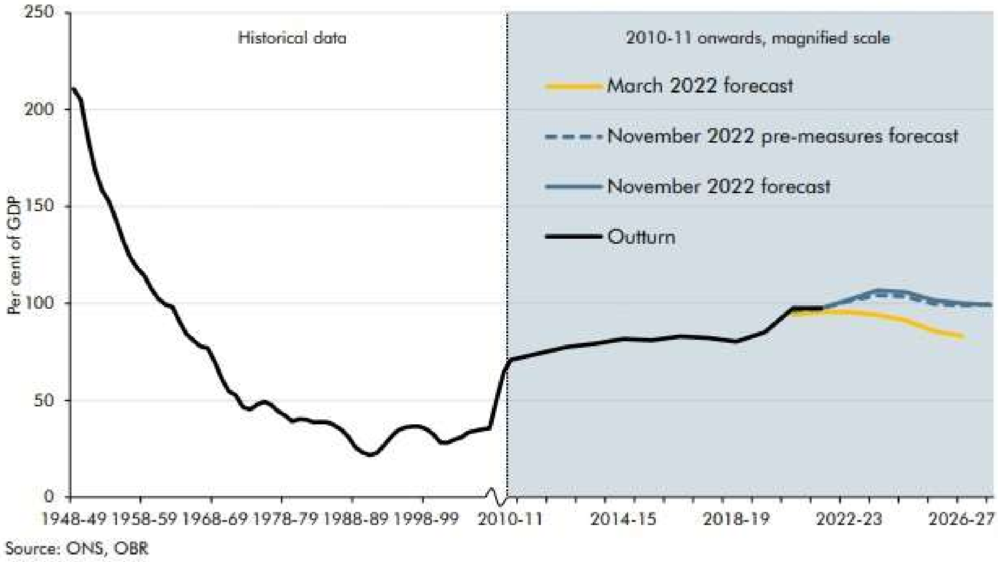


Source: ONS, OBR

Debt, debt, and debt

The UK's underlying debt ratio prior to the global financial crisis of 2008 stood at around 34%. Post-crisis, this rose to 70%. Following the Covid-19 pandemic, it went to 80% and now, in the wake of Russia's invasion of Ukraine, it stands at almost 100%. These three 'shock' events in the space of 15 years have put the UK economy under pressure in a way not seen since the immediate aftermath of WWII.

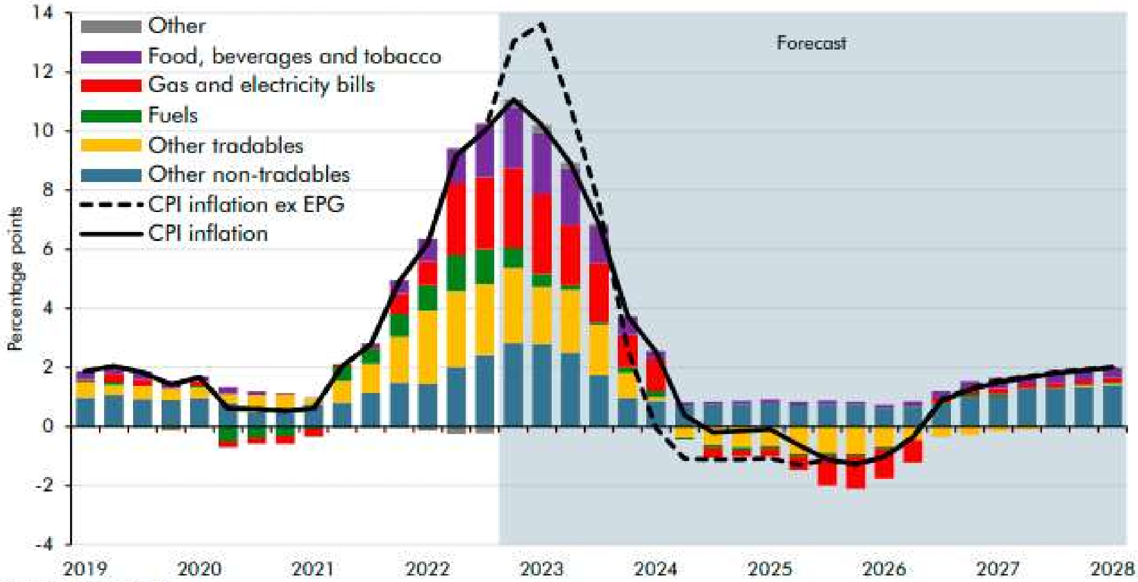
Chart 2: Public sector net debt



In identifying what it sees as the main potential positive catalyst for the UK economy, the OBR points to an end to the hostilities in Ukraine. And in identifying what it sees as the major risk, it points to an escalation of hostilities in Ukraine. Which may seem simplistic, but serves to illustrate the impact that the price of energy has on the UK economy. Post invasion, energy costs peaked at a ten-fold increase on previous prices. They have now settled at around a four-fold increase, which the OBR estimates to be the likely ongoing level for as long as the situation in Ukraine remains as it is. This is consistent with our June 2022 Insight: *War or Peace: Politicians and Bankers should fight inflation.*

The knock-on impact to other areas of the economy has been swift and brutal. Inflation, initially dismissed as a "transitory" issue in 2021, has soared, and central banks have raised interest rates to fight it. UK inflation is predicted to peak at 11% (indeed the October print was 11.1%) this quarter before dropping back over the course of 2023. The OBR does not see the Bank of England's usual 2% target coming back into play until 2027. Interest rates are expected to peak at 5% in the second half of 2023, only paring back incrementally from the start of 2024.

Chart 3: UK inflation composition outlook

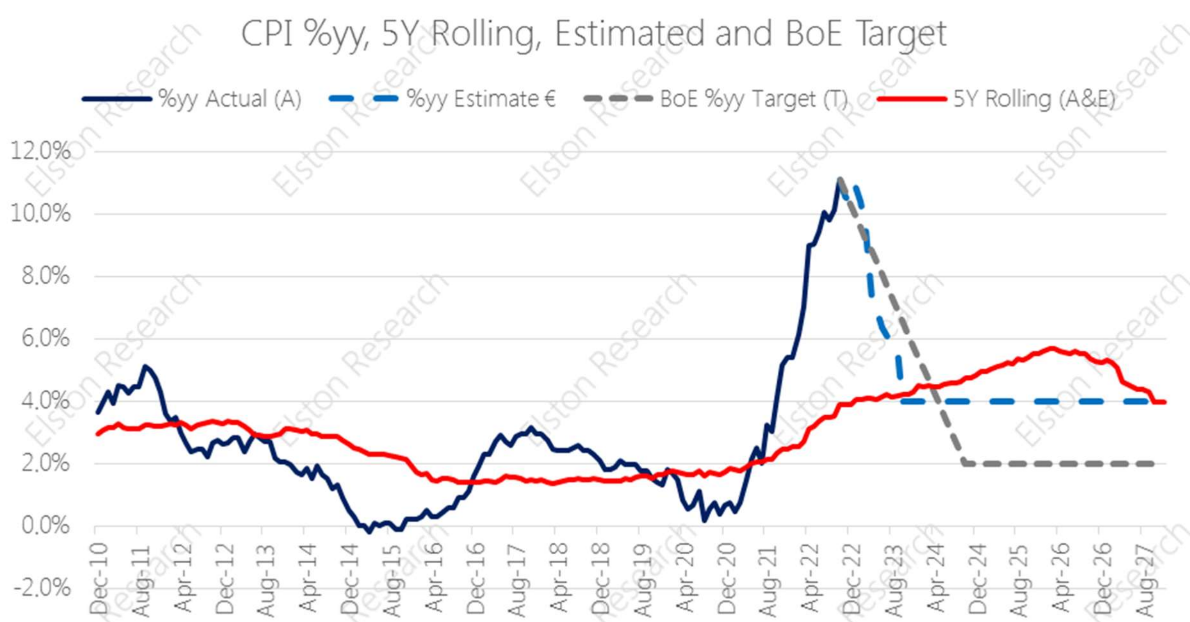


Source: ONS, OBR

Our view is that these types of forecasts are highly variable, hence our focus on 5 year break-even inflation rates as a day-to-day indicator of forward-looking inflation expectations.

Our chart below shows actual inflation figures, our estimated inflation forecast (reaching 4% by end 2024), BoE target inflation (reaching 2% by end 2024), backward-looking 5 year rolling annualised inflation, using our estimates, and forward-looking 5 year annualised breakeven inflation rates.

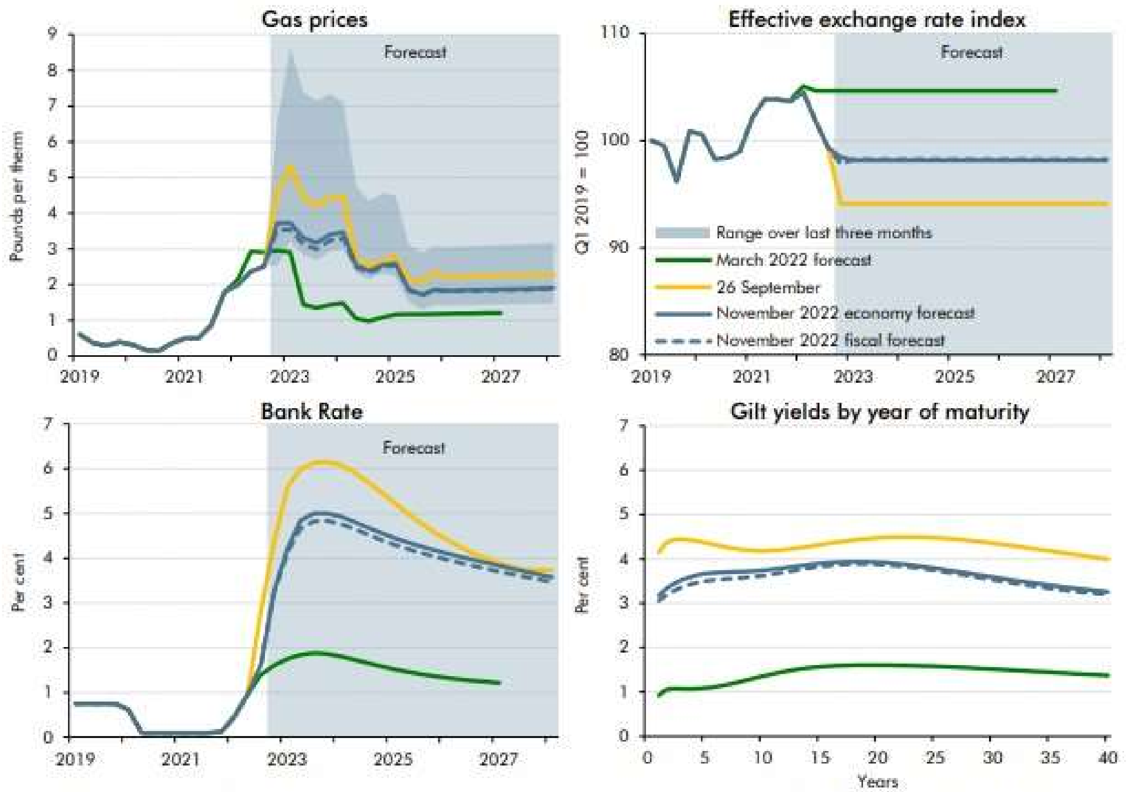
Chart 4: Elston inflation outlook



Source: Elston research, Bloomberg data

The combined pressure of the economic headwinds illustrated below are driving the UK into a recession (consistent with Bank of England estimates) from which the OBR only forecasts recovery in 2024. Gilt yields across the curve are high, Sterling is weak and the cost of servicing the national debt has more than doubled in the past year to 4.8% of GDP, owing to interest rate rises.

Chart 5: Headwinds facing the UK today



Note: November 2022 economy forecast is an average of the 3 working days to 26 October and the fiscal forecast is averaged over the 10 working days to 4 November. Range over last three months is up to 4 November. Effective exchange rate is comprised of the US Dollar, Euro, Canadian Dollar, and Japanese Yen, weighted by trade.
Source: Bank of England, Bloomberg, Datastream, OBR

What does this mean for portfolios?

The implications for investors are significant.

Equities

The first read-through from this outlook is to consider equities in a more granular context.

Within UK equities, this outlook suggests that large cap (which is more internationally oriented) will continue to outperform domestic-oriented mid, small and micro-cap equities. From a factor perspective, we expect exposures with a Value/Income bias to continue to be more defensive relative to other factor-styles.

While UK equities have proven resilient relative to the US in 2022 owing to their Value bias, this outlook suggests that on a relative basis, the US is becoming more attractive as it is more likely to emerge from recession sooner, more likely to contain inflation quicker (thanks in part to the strong dollar), and more likely to start easing prior to the UK.

European equities could remain under pressure for the same reasons as the UK: the combination of recession risk, soaring inflation and weaker currency.

In short, we suggest reducing any overweight to the UK to a more neutral posture in favour of US/world equities (world equities are driven largely by US equities).

Within world and US equities, we continue to advocate being selective and avoiding sectors where valuations still seem stretched relative to new interest rate regime. One way of achieving diversification within world equities is to consider diversifying exposure using a sector-focus, a factor-focus or a thematic-focus.

Alternatives

Alternative Assets: as the main driver and main downside risk to forecasts is ongoing inflation-related pressure, we believe an allocation to alternative assets (property, infrastructure, gold, commodities) continues to make sense as an asset-based diversifier and inflation-hedge.

Alternative Strategies: given the challenge for nominal bonds in a higher inflation regime, we see alternative strategies, such as selective Absolute Return funds, as having a role to play to deliver a return-premium to bonds, with bond-like volatility, as a risk-based diversifier.

Bonds

Against the backdrop of a recession and in spite of inflationary pressures, there is scope to revisit the bond market where opportunity permits. Currently we believe that short-dated bonds (both in GBP and USD) look attractive as the economy heads into recession.

We will start to look at longer-dated bonds when inflation is expected to get past the peak and there is downside risk to interest rates. We're not there yet. It is also worth noting that while the interest rate tightening cycle in the US and UK was fairly synchronised, the extent and level of rate hikes and the timing of any pauses and future declines may be less synchronised owing to the differing economic prospects of their underlying economies.

Summary: yield is back

The return of yield – after an absence of more than a decade due to near-zero interest rate policy – means that given the fragile economic outlook, focusing on equity income, short-dated income and multi-asset diversified income underpins portfolio resilience.

Currently, the key market drivers for the UK as defined by the OBR are the state of Russian gas exports to Europe, rising government bond yields internationally and a strengthening US dollar. The medium-term fiscal outlook for the UK is significantly poorer than it was 6 months ago, owing to high inflation, rising interest rates and a weak currency. While the government's energy price guarantee will keep inflation down by between one and two percentage points, the policy cost for this is a function of the highly variable energy price outlook. In its most recent budgetary announcement, the Treasury has left itself with considerably less headroom to withstand any future shocks. The UK looks set to remain in this position of vulnerability for some time to come. The poor outlook for the UK makes it even more important to have a globally diversified portfolio and an active approach to asset allocation across and within each asset class.

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