



U.K. Budget Experiment Tests Markets

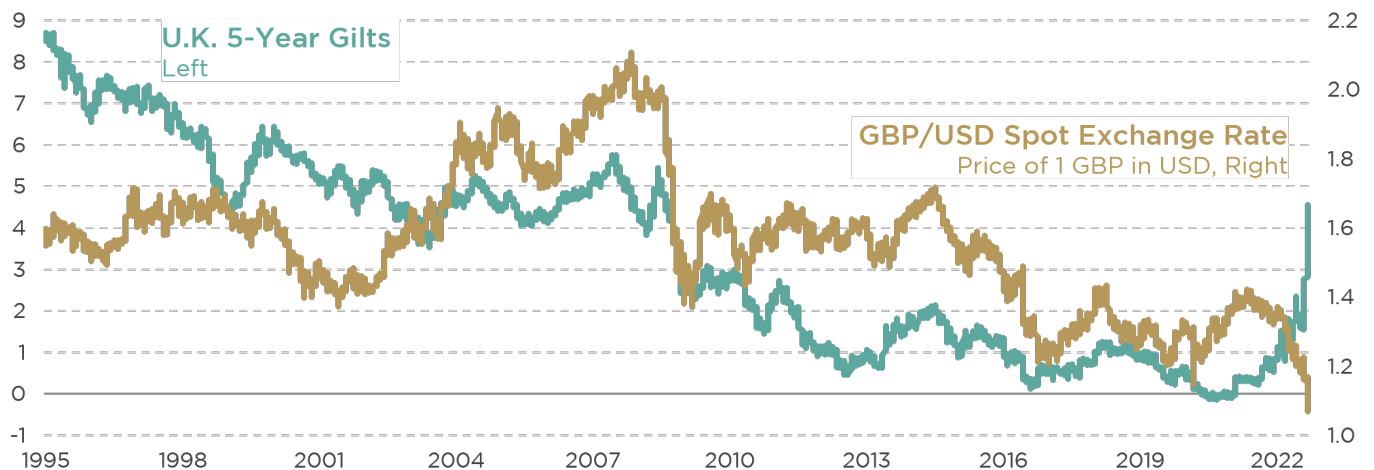
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There has been quite a stir going on in the U.K. For the past several weeks, the world was transfixed by the historic funeral proceedings for Queen Elizabeth II. Now, grave new concerns have taken over the headlines, triggering a sell-off in U.K. assets. Gilt yields are skyrocketing, and the pound is plummeting, even touching a record low against the U.S. dollar (USD). What has been driving the enormous moves in the U.K. currency and bond yields (see [Figure 1](#) and [2](#))?

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U.K. 5-Year Gilts and GBP/USD Spot Exchange Rate

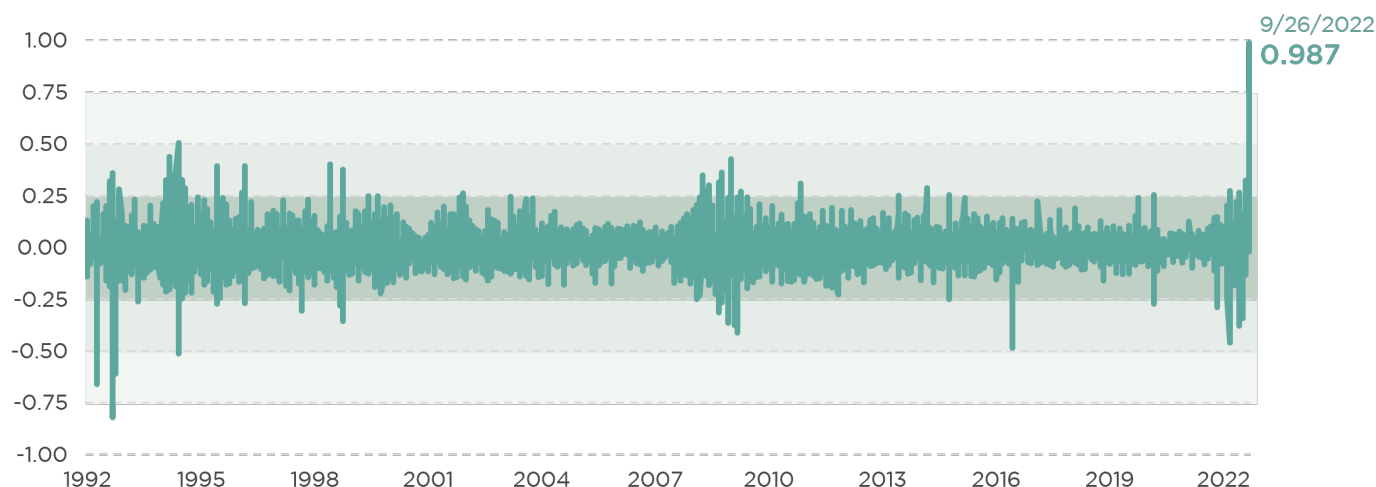
% (Left), \$ (Right), As of 9/26/2022



Source: Brandywine Global, Macrobond

U.K. 5-Year Gilt Yields

2-Day Change, As of 9/26/2022



Source: Brandywine Global, Macrobond

For starters, one major culprit is the unveiling of the government's "mini" budget, which is anything but mini. It contains a few surprises that caught the market off guard. On one side are tax cuts; energy subsidies are on the other. The market generally was expecting the energy subsidies but not the scale of the tax cuts. The new budget calls for a significant cut to the top tax rate, bringing it to 40%, down from 45%. This move, which will benefit the highest earners, is essentially trickle-down economics on steroids. On the other end of the scale, the lower rate gets a meager haircut to 19%, down from 20%. Essentially, these changes give top earners a significant boost to their disposable income, which is also potentially a type of inflationary measure—all while the country is facing steep inflation, an energy crisis, and potential recession. So of course, the politics and communications have gotten a little out of hand.

Furthermore, the energy subsidies could result in an almost unlimited liability for the government. In contrast, some European governments may provide an initial allowance—a subsidized cost—but the rest comes down to the energy market and usage. So, the optics of the U.K.'s unlimited liability combined with the tax cut to the highest earners are poor. There is a cost-of-living crisis in the U.K. that will need to be funded by increased fiscal spending when interest rates are already high. After two back-to-back 50-basis points (bps) moves in rates, and pound sterling approaching parity with the USD, everyone is now waiting for some type of shock-and-awe intervention from the Bank of England (BOE). The BOE has stepped in to stabilize the bond market, pausing its program to sell gilts and purchasing long-end bonds for a set time period, but the central bank still finds itself significantly behind the curve with no scheduled meeting for some time. The fact that one member of the monetary policy committee was calling for only a 25-bps hike the other week shows just how far behind. Dual deficits and now gilts and sterling selling off at the same time put the U.K. in a worrisome position.

Looking ahead, the government is betting big that trickle-down economics will work, and in two to three years things will be okay. With sterling (GBP/USD) hovering just above parity (1.0), a whole host of U.K. assets could become very attractive. Furthermore, the U.K. economy is hugely reliant on foreign direct investment (FDI) to fund a lot of spending. Again, at some point, rates and assets will look very attractive to foreign investors. In the meantime, the government could do a better job at communicating the supply-side reforms that are a critical component of these spending programs. Instead, the tax cut for the wealthy has grabbed all the headlines.

While the situation in the U.K. has been garnering global attention, it likely will remain a local story. With one of the lowest debt-to-gross domestic product (GDP) ratios across the G7 countries, the U.K. government likely believed it was in a better position to introduce this type of budget package. However, the market's reaction, with gilt prices and the currency moving in the same direction, has been a huge warning signal to the rest of the

world. As other countries face potential changes in government over the next couple of quarters, including Brazil, Italy, and even the U.S. with mid-term elections around the corner, they would be wise to learn from the fallout of the U.K.'s latest fiscal and monetary experiment.

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