MACRO THOUGHTS

INVESTMENT RESEARCH / MARKET COMMENTARY / CONSULTANCY

New PM's to do list

Over the past month, we have provided reports and interviews on the UK economy under a new PM, and been asked a number of questions on how to solve the problem of energy costs.

We have always found that the UK consumer is resilient and sentiment can quickly rebound from a crisis, so long as inflation is controlled and the property market supported. We recognise that the UK economy is unique. It is almost 80% Services-based and not so reliant on manufacturing economies such as China, unlike Germany, for example, but does depend on a strong global economy; therefore, while May and Carney reacted to Brexit by devaluing Sterling and undermining consumer confidence (when it was most needed), we argued that the UK economy is most susceptible to inflationary pressures and so thrives better with a strong currency.

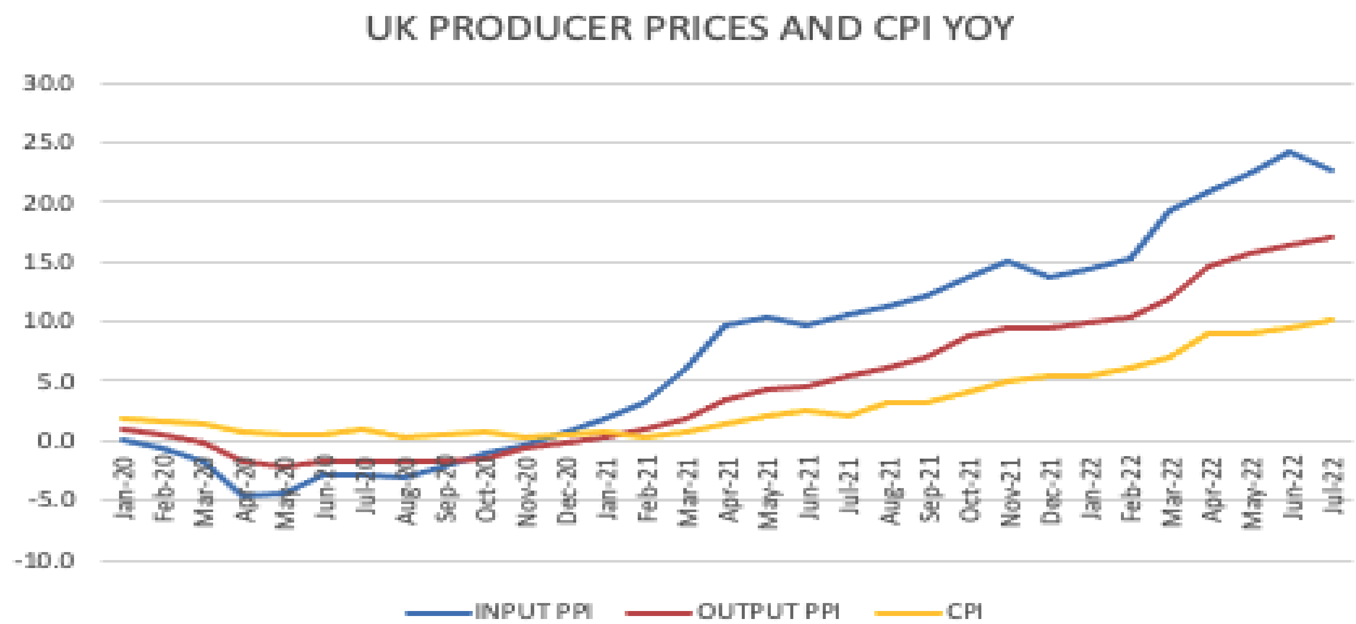
*In our report, '**UK economy may not be all doom and gloom, though we doubt there will be a boom'**, which was echoed in the press, we highlight the problems and positives - **Q2 GDP being supported by a 3.50% increase in Business Investment.***

Just over three-quarters of all businesses in the UK are in the services industries and they account for 79% of employment. These include retail, hospitality, professional services, business administration and finance. In 2021, services industries contributed £1.7tn in Gross Value Added (GVA) to the UK economy, 80% of total UK GVA.

The fastest-growing start-up sectors include services-on-demand (e.g. IT, mobility, parcel collection and delivery, and workforce provision), 'edtech' (education technology) and 'proptech' (property technology companies, e.g. Zoopla).

Non-manufacturing industries continue to grow in the UK; it is reported that the UK film and high-end TV production sectors could be worth almost £8bn by 2025, creating jobs and attracting foreign investment. BBC Elstree and Elstree Studios have been joined in the area by a huge new Sky film studio, with 13 sound stages, covering 27.5 acres.

Macro Thoughts' August 24 report on the UK economy has since been echoed in the Press, with several of our suggested strategies seemingly in line with the thoughts of Liz Truss, who is said to be considering a 5% cut in VAT, to 15%.



We said in our report:

'Current projections suggest that the UK price cap will rise from £1,280 for the winter of 2021/22, to a forecasted high of £5,300 by the Spring of 2023; cutting green taxes, or a limited adjustment to VAT, will only have a small impact on bills, but a cap can be funded to keep energy prices down in the short term. ***Governments can borrow over decades to spread the costs, but households need to pay for energy as it is supplied and, in some cases, in advance of its use.***

The government could issue £50bn of energy Gilts and lend the proceeds to energy companies, who might be given 5 or 10 years to pay back the loans and recuperate, in more normal times; this would, therefore, keep CPI lower, less consumer support would be needed, and this would offer an incentive for foreign companies to invest in the UK.

The overall cost of shielding consumers from the increased price cap is estimated to be £100bn, therefore, 4% Gilt rates will add £4bn to government *debt, which may be passed on if energy companies are given loans to keep the energy cap low. Without government support for energy, businesses will collapse and unemployment will rise, and become a greater burden on the exchequer.* ***£4bn is roughly the net borrowing of the UK government per month, however, projected reduction in CPI from freezing energy bills is 3.5%,*** *and this should keep UK interest rate down.'*

So, if MT was PM, we would consider…….

Energy

- Issue £50bn Energy Gilts over 10 to 20 years at market plus 5bp to 10bp, which will encourage institutional and pension buyers, as well as foreign buyers, and would include tax incentives to hold on to the Gilts, long term. UK bill payers would be allowed to buy the Gilts and would get a discount, or a bill cap without fees, on their energy bills for doing so

- £30bn would be given in the form of loans to energy companies to cap bills and develop R&D. Ensure energy companies work together to secure the energy industry in the longer term, and include a government-appointed member to an energy company committee

- Energy companies will be capped on profits and boardroom salaries and bonuses

- Build the necessary number of nuclear power stations over 10 years

- Build relationships and long term contracts with gas suppliers (Qatar, US, Norway, Morocco). *Costing around £20bn, connecting a 10.5 gigawatt solar and wind farm, the first phase of the world's largest undersea energy cables (4x2,361 miles) will connect Morocco with the UK (Devon) by 2025-27, and eventually extend to Scotland*

- Rethink gas storage, including opening Rough, and look for alternatives, including pipelines and storage with African economies. *In mid-August, it was reported that consent had been sought from the North Sea Transition Authority (NSTA) and an agreement was expected between the government and Centrica on state support to reopen the Rough gas storage facility, which previously accounted for 70% of Britain's natural gas storage capacity*

- Rethink and develop next generation solar panels and home insulation

- Restrict energy use in commercial buildings – lights to be turned off when not in use - and reduce advertising board illumination

- Begin a programme to bring more regions onto the mains grid for utilities, reducing oil deliveries by road and ensuring supplies

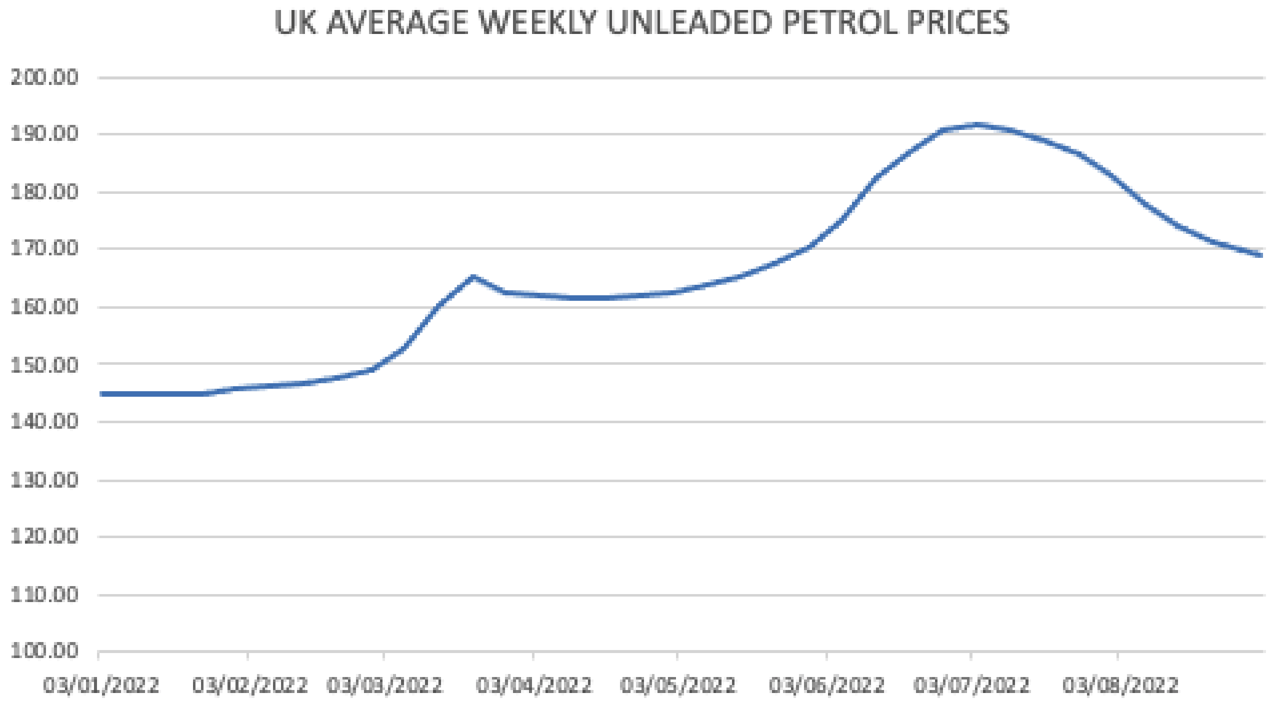
- Consider developing transport by waterways

- Greater investment in hydrogen fuel, as an alternative to electric vehicles

- Build green, super-recycling centres, to encourage bio-fuel, etc., regionally, away from urban areas
- Work closer with the fishing industry, on windfarm growth and to monitor sewage spills

- Encourage school intake to be more local, to lower school run journey time and costs

- Establish a regulator to more closely monitor wholesale petrol prices compared with retail prices and fine companies that consistently overprice, react swiftly to raise but slowly to cut (US gasoline prices fell in June, but UK prices didn't peak until late July)



Finance

- Break the 50 year out-dated mould of monetary policy decisions, to act proactively and not reactively

- BOE to target the actual economy (rather than financial markets); Inflation, (Consumer and Producer), Employment, Growth, Trade, Productivity

- Target an inflation range of between 1% to 3%, but differentiate between Core Inflation, excluding Food and Energy, and discretionary and non-discretionary spending

- BOE voting members to include those with industry and business backgrounds, reducing the number of traditional economists with BOE/lecture room backgrounds to the minority

- BOE tasked to support Sterling and discouraged from devaluing the Pound (which fuels inflation in the UK)

- Increase the power of the FPC in monetary policy decisions - the BOE Governor and Chancellor should be committee members, but not Chair

- Set up a sub-committee of the FPC, comprising cross-sector representatives, including, for example, a CEO from banking, retail, manufacturing, and energy, along with a government appointee and a trade union leader

- Move the Treasury closer to the monetary policy process, including QE and QT

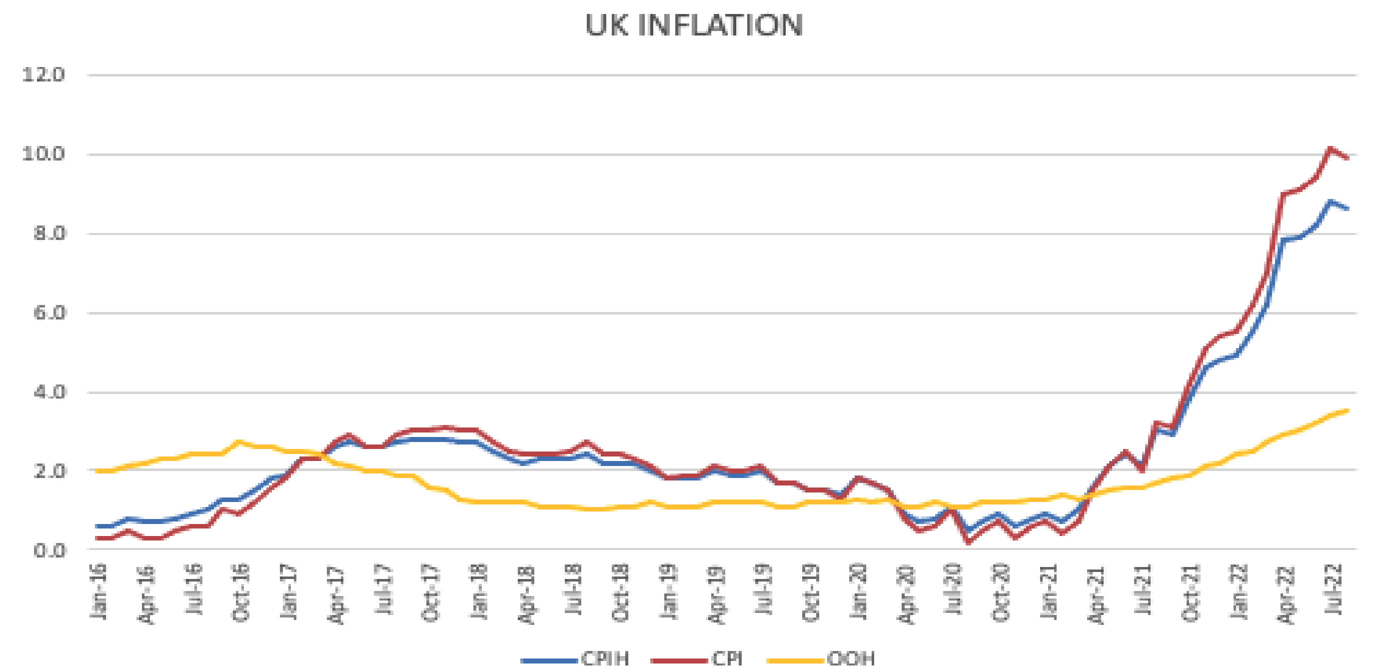
Keith Grindlay – September 5, 2022

<u>In thee we don't Truss</u>

The UK economy will usually bounce back from economic volatility more quickly than most and, not being so reliant on manufacturing, should not suffer from the slowdown in China as much as, say, Germany. However, the fledgling UK government has gone beyond what even we could have envisaged.

Our August 24 report commented: 'The government could issue £50bn of energy Gilts and lend the proceeds to energy companies, who might be given 5 or 10 years to pay back the loans and recuperate, in more normal times; this would, therefore, keep CPI lower, less consumer support would be needed, and this would offer an incentive for foreign companies to invest in the UK.....4% Gilt rates will add £4bn to government debt, which may be passed on.....Without government support for energy, businesses will collapse and unemployment will rise, and become a greater burden on the exchequer……£4bn is roughly the net borrowing of the UK government per month, however, projected reduction in CPI from freezing energy bills is 3.5%.....'

Our costing analysis in August was based on Gilt yields at 4% (markets were pricing UK rates being at 3.50% by Christmas through the Sonia market) and we repeated our warning to expect higher yields with a steeper curve in last week's 'The Week Ahead'. We had been surprised that markets hadn't been more aggressive in pricing higher yields ahead of the Budget and the FOMC meeting.

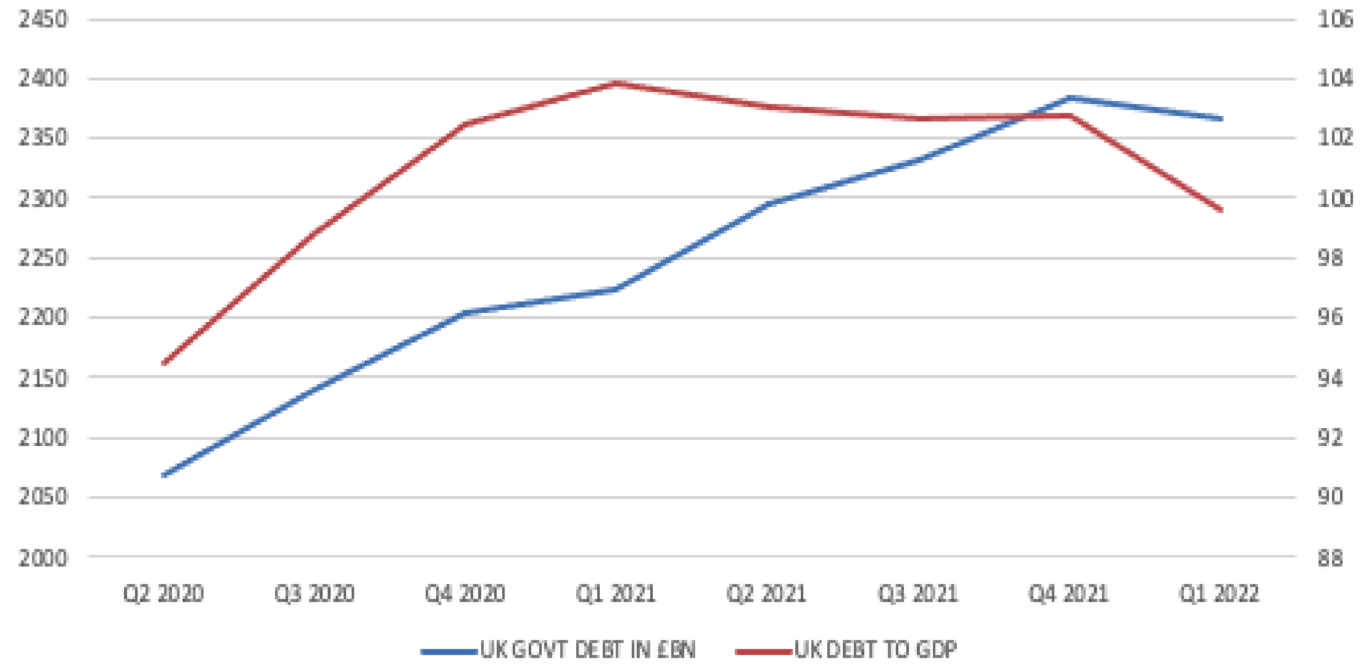


The budget was announced with the aim to create higher growth and to invite more foreign investment, however, the accompanying policies go far beyond what is comfortable with tax cuts and the changes have unnerved markets. Bankers' salary caps were an EU rule that would inevitably be reversed at some point and, as JP Morgan have recently announced, operations were already being brought back from Europe, but was it necessary to encourage tourist spending, when the Pound is so weak anyway? Any reaction in property markets from the changes to stamp duty has been wiped out by the 50bp rally in Gilts.

We would have preferred a 3% reduction on VAT, extended for up to two years, and perhaps markets would have reacted more positively had this been announced. At the next election, when the global economy should have recovered from inflation and growth shocks, a Truss manifesto could have included the radical changes made today.

It was inevitable that there needed to be a rise in the amount of debt issuance to tackle the energy crisis - and coming out of a shock such as COVID, debt levels globally are already high - but our expectation of long term borrowing for 2026 and beyond is not as pessimistic as some, because they underestimate the potential gained from tax incentives, such as maintaining the low level of Corporation Tax, resulting in an increase in FDI. We expect the UK's Financial Services sector to increase its importance to GDP and, along with global growth, we anticipate global economic activity to pick up from 2024. In contrast to the UK, Spain's

Socialist-led coalition government is planning a temporary higher tax rate on the richest 1% of the country from next year, in addition to its windfall taxes on large energy companies and banks.



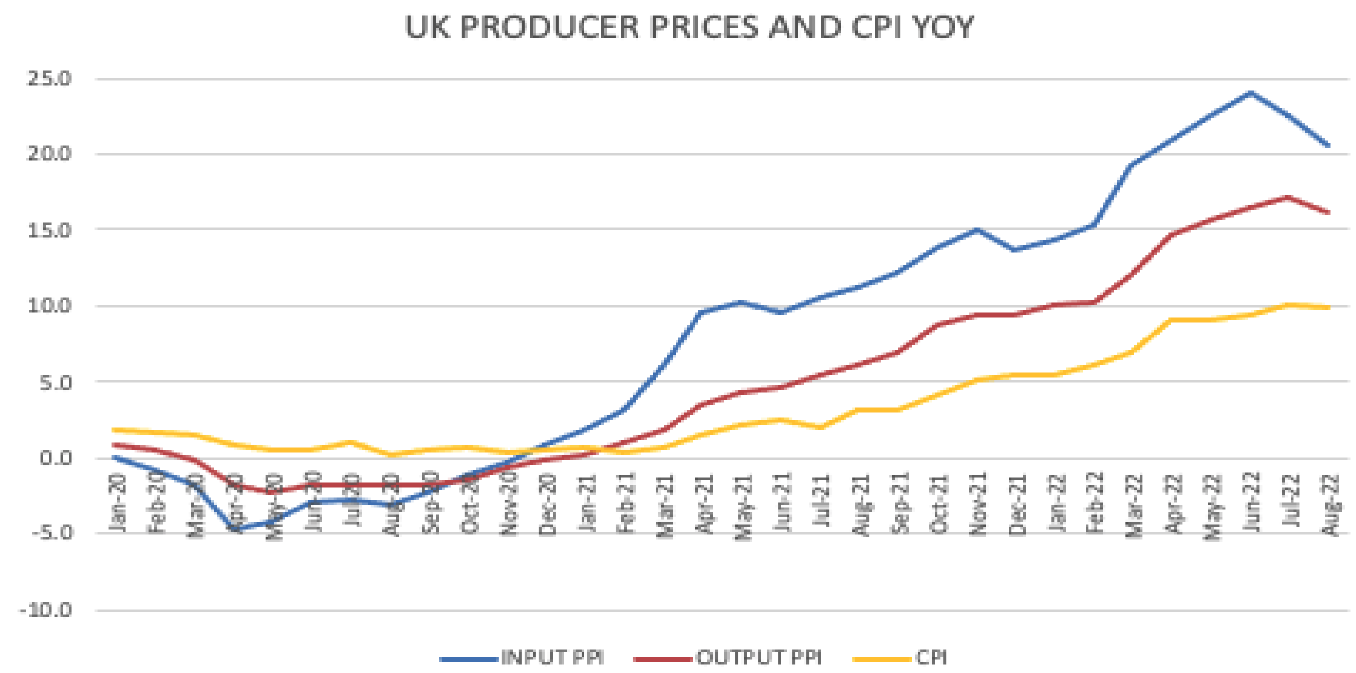
While the OBR will release their figures either side of the New Year, their forecast had been for a steady improvement in government debt to underlying income from just under 85% to just above 80%. While some forecasts are now targeting a rise to 95% by 2026, we don't see this rising above 90%.

With the UK Debt-to-GDP the second strongest of the G7, we said in our August report: '*UK GDP may have dipped into a second quarter of negative growth, but it was the first contraction in over a year, and Business Investment increased by 3.50%, reversing a -0.6% decline in the first quarter. There were positive contributions from consumer-facing services, and the UK data didn't rely on elevated inventory levels for support.*'

Latest data for Q1 showed:

- UK government gross debt was £2,365.4bn, equivalent to 99.6% of GDP
- UK government deficit (net borrowing) was £15.8bn, equivalent to 2.6% of GDP

Central government day-to-day expenditure increased by £3.4bn yoy, to £76.5bn, with a £2.3bn increase in debt interest payable and a £2.8bn increase in net social benefit payments, being partially offset by a £1.5bn reduction in subsidy payments. Central government receipts were £78.2bn in July, an increase of £6.1bn on July 2021.



Prior to the Budget, and as interest had been due to be paid to high street banks by the BOE on reserve balances, it had been reported that the government was considering changes to the BOE QE programme, as interest paid on reserves will be greater than the income from gilts when rates rise above 2½%, under the QE indemnity with the Treasury. Under one option being considered, interest paid on some deposits held by commercial lenders at the BOE would be scrapped, potentially saving more than £10bn a year. It is reported that zero-rating the £450bn of QE introduced during the pandemic would save around £10bn a year (equivalent to approximately 2% on income tax). Banks themselves will benefit from the previously planned rise in Corporation Tax being scrapped.

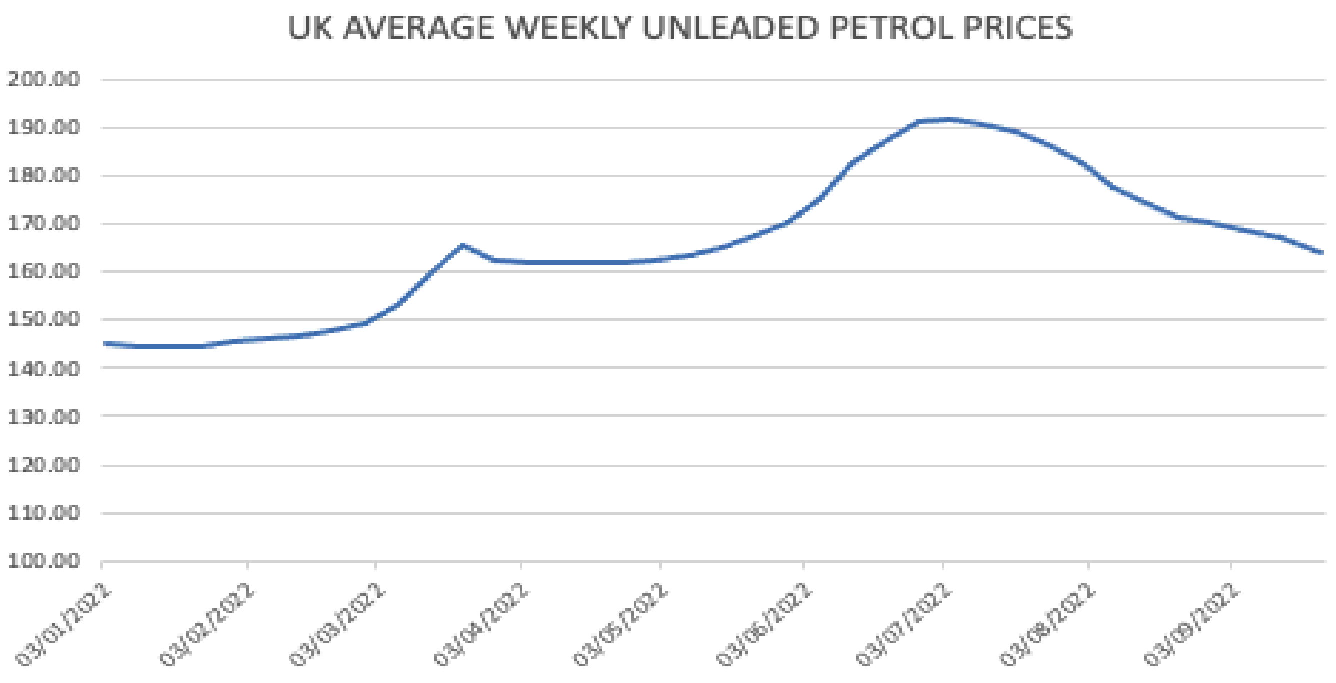
A windfall tax on energy companies, introduced earlier in the year by previous Chancellor Sunak, is expected to raise around £28bn by 2026.

We maintain that the UK economy does better with a strong Pound and that the Fed has caused untold problems for central banks around the world. The BOE had to react to the Fed and balance their decision against a budget being announced the following day. When 5year Gilt yields move 0.50%, Sterling drops and CDS starts to price as an EM, does a ½% or ¾% rise in the base rate matter that much?

The strength of the Dollar, along with the pageantry of the Queen's funeral, which was viewed by half the planet, was enough to bring American tourists in droves anyway, therefore it was unnecessary to cut duties and, far from encouraging investment, there is a risk of an acceleration of hostile takeovers of UK companies, with technology and profits being repatriated back to the domain of the new parent company. With UK companies at the forefront of technologies such as the development of hydrogen energy, that will now be difficult to defend and the benefits of the R&D and knowledge within these companies could be lost. When British chip designer ARM was approached by rival Nvidia for a $40bn deal in 2020, GBPUSD was eighteen big figures higher than Friday's below 1.09 close. In 2021, it was reported that ARM China was attempting a management take over.

It is a brave move by Truss, but if, as we expect, global growth will be hit next year and inflation settles back quickly towards a range between 1% and 3% (which we believe central banks should be mandated to target), then FDI will be at the forefront of government policies globally in 2023.

The budget was unprecedented and a shock to markets because it's seen as a one-off hit, but the interest payment our analysis was based on equates to just one month of government spending, which can be spread over 10 years. At the time of COVID, we highlighted the debt left from WW1 and WW2. The ratings agencies might put the UK on 'watch', but we think other countries will eventually need to follow.



Keith Grindlay – September 23, 2022

UK markets have recovered; volatility was not just about the budget

While there were things about the budget that went beyond what even we expected, there are as many questions to be asked over why the market reaction was so severe. Is there no experience left of those who traded Short Sterling (the widow maker, which could move 15bp in an hour on a whim), since QE was introduced? We have sympathy towards the sentiment to support growth and encourage foreign investment, the aims of the budget, but for a first budget, agencies were not prepared, it went further than was necessary and inexperience at government, market and central bank level has been exposed.

We do not subscribe to the notion that it is the UK budget alone creating the volatility that hit global markets - economies the size of the EU and US should be big enough and strong enough to withstand what happens in the UK - but it does highlight the cracks being created by global tightening of financial conditions led by the Fed; weaknesses were being exposed long before Truss assumed the leadership of the UK government.

Truss's policies may be unconventional, yet is it wrong to have tackled an energy crisis that threatens jobs and businesses, with stagflation already seeping into the economy? The vocal reaction will do more damage than good; questioning established doctrines on tax, pension fund risk management and central bank theories is long overdue. Which voter would have preferred their energy bills to have doubled or trebled, or first time buyer preferred to be paying stamp duty to get on the ladder? There was an outcry when national insurance was raised and now there is an outcry when it is cut and, if bankers' bonus caps are ended, won't that bring more taxes in? Governments globally should be very concerned about the growth of their economies, the rise of interest rates and the weakening of their currencies.

- The energy crisis needed to be managed and few doubted the cost would be around £50bn; could energy bills have been allowed to rise above £5k pa for the average household?
- The BOE's revised QE programme will result in the buying of £65bn
- Sunak's tax hikes (which had been heavily criticised at the time) were cancelled, including the 6% rise in Corporation tax to 25%, and this had been expected prior to the budget. Kwarteng said this cut would bring £19bn a year back into the economy, though that is open to interpretation
- The bank surcharge rate will remain at 8%, having been set to fall to 3% in April 2023, and April's National Insurance increase is to be reversed from November 6
- Duty on alcohol will no longer be increased and this is aimed at helping pubs and restaurants
- Ending the cap on bankers' bonuses will increase tax revenues
- Revising Stamp Duty will help new home buyers and few argued with the freezing of this during COVID. This should help first time buyers and regions where house prices are lower than the rest of the country
- Reducing Duty on tourists' alcohol purchases was unnecessary when the Pound has fallen to such low levels
- Income tax reductions help any tax payer, though lowering for high end tax payers could have waited until after the next election. The government will bring forward the 1% reduction in the basic rate of tax to 19% to April 2023, bringing the reduction forward by 12 months
- Winding down the Office of Tax Simplification will save money
- With a new government and budget, the OBR needed time to gather their figures before giving an accurate account. There are those who can give out their analysis, some of which were very early, and we found their numbers to be too pessimistic
- New investment zones will offer businesses tax cuts and reduced regulation to encourage growth and investment in regions across the UK
- Most controversial, but perhaps least advertised by the critics, is the change to benefits to encourage over 50s to stay in work. Unfortunately, this may not be an economic issue, and many over 50s may be finding it had to get back into work after COVID
- Trade union regulations were tightened as the number of strikes increase, particularly by transport unions
- The ONS has admitted that its forecast for a recession was wrong, as the economy grew by 0.2% in Q2

The question was even raised whether this was another ERM moment; there is already a record number of Funds whose profit swings can regularly be in the 10%, 20% 30% range every year, making significant profits, and no doubt the swings will also have led to losses. The UK's withdrawal from the ERM is recognised for the Soros-type trader who made their killing taking on the BOE, but in today's markets things are very different (and we would prefer to recognise those who faded higher yields buying Gilts in the teens and running them to maturity, which for some would have been with Gilt yields below 1%).

In last week's 'The Week Ahead', we suggested using auctions and Fed-speak to start introducing Investment Grade Bonds to portfolios. Having seen bond yields running at or below 1% for years, Pension and Investment Fund managers should have been prepared to actively take advantage of locking in long term real returns, with yields at 4% for government bonds, 5% for investment grade bonds, and 6% for High Yield.

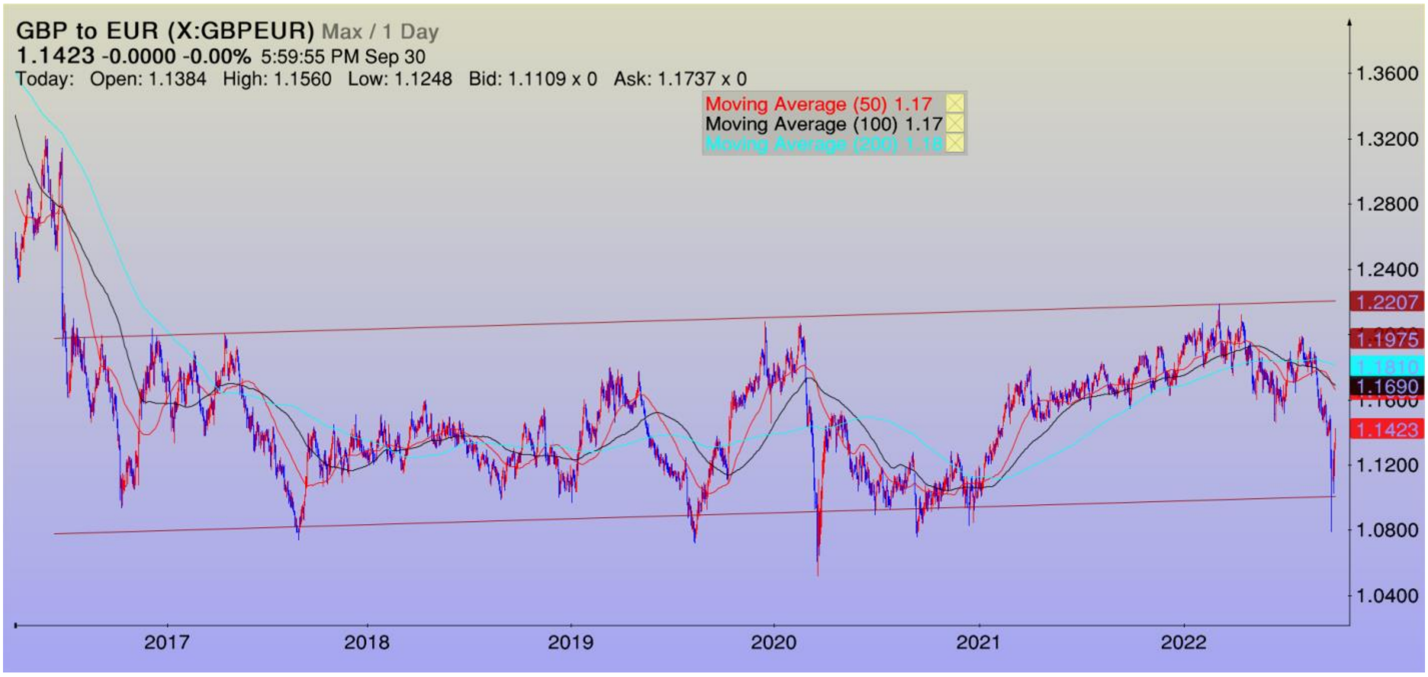
Those who failed to do so are failing their investors and therefore the BOE or the FCA must then look at why pension funds, LDIs and others who had problems with margin calls, are potentially unable to manage their risks. Although the moves in the market were volatile, they were no way as extreme as they might have been, while Hedge Funds purely using VAR are open to risk beyond their matrix. Market reaction and performance YTD highlights the fund managers who have successfully transformed their portfolios from passive investments to active.

Clearly, the BOE had been aware of the risks, and could have raised rates by 75bp prior to the budget, and with the Fed continuing their rhetoric for higher rates, higher yields were inevitable – we based our pre-budget analysis, in August, on 4% yields.

Short dated yields had already risen to the highest since 2008, before the budget. In April 2008, one year Gilt yields rose from 4.35% to 4.85%, the range was 4.55% to 5.05% in May 2008 (stronger Retail Sales data had prompted a sharp selloff in Short Sterling) and in June 2008 yields peaked at 5.25%, as the global economy faltered; from June's peak, yields would fall to 3% by the end of the year.

Global bond yields look set to be reversed and QE reintroduced in the US and EU in 2023, as economies fall into recession (even Fed members are saying they will be surprised if this doesn't happen). We continue to favour introducing Investment Grade bonds into portfolios.

Sterling has gained more than 7% from its all-time low of $1.0350 set early Monday, climbing to as high as to $1.12 in Asian trading on Friday.



While markets have been over-focused on the UK, Italian yields are higher and spreads wider than at the time of the June ECB emergency meeting, the PBOC has warned their markets against speculating against the Yuan and Chinese stock markets, as another property developer is in trouble, and damage to the Nord Stream 1 & 2 pipelines has economic and geopolitical implications, whilst Florida is suffering the worst floods in decades, all of which should have a greater impact on the global economy.

The fledgling UK government will again come into focus next week at the Conservative Party conference, but with four PMs since the Brexit referendum, some kind of stability needs to be preserved.

Keith Grindlay – October 2, 2022

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