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Hymans Robertson Investment Services (HRIS)

Labour's Budget: Trick or Treat?

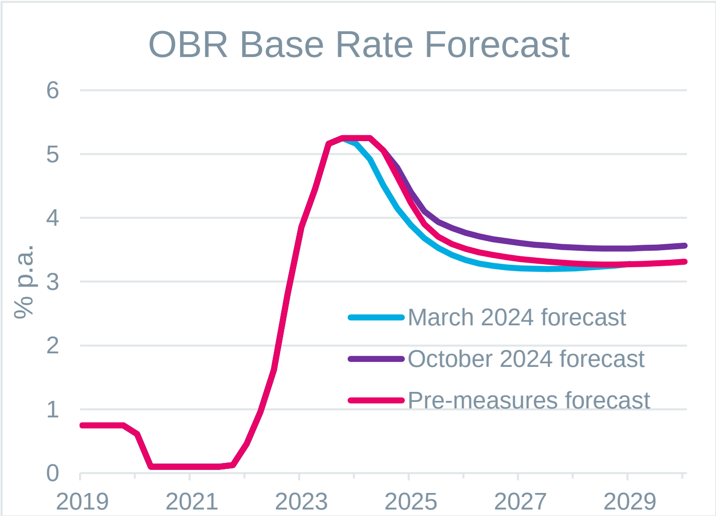
November 2024

- Labour's recent budget included significant increases to government spending, taxes, and borrowing. The Office for Budget Responsibility ("OBR") stated they had only seen larger increases to borrowing in the immediate aftermath of the Global Financial Crisis and Covid.
- Economic growth should be stronger over the near term but there's little impact over the medium term. Inflation and interest rate forecasts are also higher as a result of Budget measures.
- The initial market impact was limited but gilt yields started to rise (due to bonds prices falling) in the afternoon following the Budget. HRIS' low gilt exposures has in part, help protect portfolios from these falls.

Labour's much anticipated first Budget was announced on 30 October. As we mentioned in our previous article on the Budget, in the context of a globally diversified portfolio, it's a relatively insignificant event (tax changes aside). Any potential impact on portfolios was likely to come through the gilt market, or indirectly through sterling. We explore any initial market impact below and what this could mean for the UK economy going forward.

Spending up, borrowing up, taxes up

A lot has been said about the sheer scale of the Budget. A £70bn p.a. increase in government spending, roughly half of which is funded by a record level of increase to taxes, the other half funded through borrowing (the OBR stated they had only seen larger increases to borrowing in the immediate aftermath of the Global Financial Crisis and Covid). However, it should be remembered that this increase to spending is in relation to the March Budget, which pencilled in large cuts to capital spending i.e. to some extent spending is just being increased to reasonable levels.



Source: OBR

A key objective of this Budget was to ensure that investors viewed the Chancellor's borrowing and spending plans with credibility – avoiding any negative impact on the gilt market. We think the fiscal rule changes[1] are sensible as it differentiates more clearly between spending for investment or otherwise. However, the new rules also opened up a considerable amount of additional borrowing capacity, or fiscal headroom. In the days prior, the Chancellor insisted that she would not be fully using this additional headroom. However, by keeping only £10bn of headroom she has left it incredibly tight and is highly susceptible to even a small amount of forecasting error. The OBR estimates that the government has only a 51% chance of meeting one of their fiscal rules, based on the uncertainty in their forecasting.

[1] Debt measure has changed from Public Sector Net Debt ex BoE to Public Sector Net Financial Liabilities.

Market reaction

Gilts

The initial gilt market reaction was relatively supportive, with bond yields falling slightly (prices rising) during the Chancellor's speech. However later in the afternoon, as the OBR released their report and the extent of the borrowing and their forecasts became apparent, bond yields started to pick up. That being said, other government bond markets also saw yield increases on the day, indicating that it was not all Budget driven. It's worth noting that there is currently only a small allocation to gilts in HRIS portfolios.

Pound sterling

The pound was fairly stable in the immediate aftermath of the Budget, with a slight strengthening in the afternoon following the increase in bond yields. There has been a bit more volatility since, with the pound giving up some ground, albeit this is partly globally driven.

Equities

As expected, global equity markets were not impact by the Budget. With UK equities, the FTSE 100 fell 0.7% partly reflecting the initial strengthening pound. The mid-cap FTSE 250 rose 0.4%, while the AIM market rose 4% as changes to IHT reliefs on AIM holdings were not as bad as expected.

Impact on growth, inflation, and interest rates

Perhaps the most important aspect of how the Budget will impact UK asset prices over the medium term, is the impact all the additional spending has on economic growth, inflation, and interest rates in the UK. The OBR estimates that the UK economy will have a growth boost in the short term, but this is negligible over the medium term.

Possibly of more consequence, the OBR forecasts higher inflation because of the increased borrowing and higher National Living Wage which leads to them expecting fewer interest rate cuts from the Bank of England this year and next (see chart on previous page). The Monetary Policy Committee will have their own views, and they've been expecting a Budget of this sort for months, but it's probably a reasonable assumption that they will act slightly slower in cutting rates as a result of this Budget. This shift in interest rate expectations is what has helped push gilt yields higher over the past day or two.

Trick or treat?

Whether this Budget will be seen as a trick or a treat will differ from person to person and there will be a vast range of views on it. One thing the Chancellor can count on as an immediate success is getting a Budget of this size through with only a moderate impact on gilt prices (so far). We'll not be able to determine the success of the wider goals of the Budget for years to come.

Jack Richards
Investment Manager

Risk warning

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