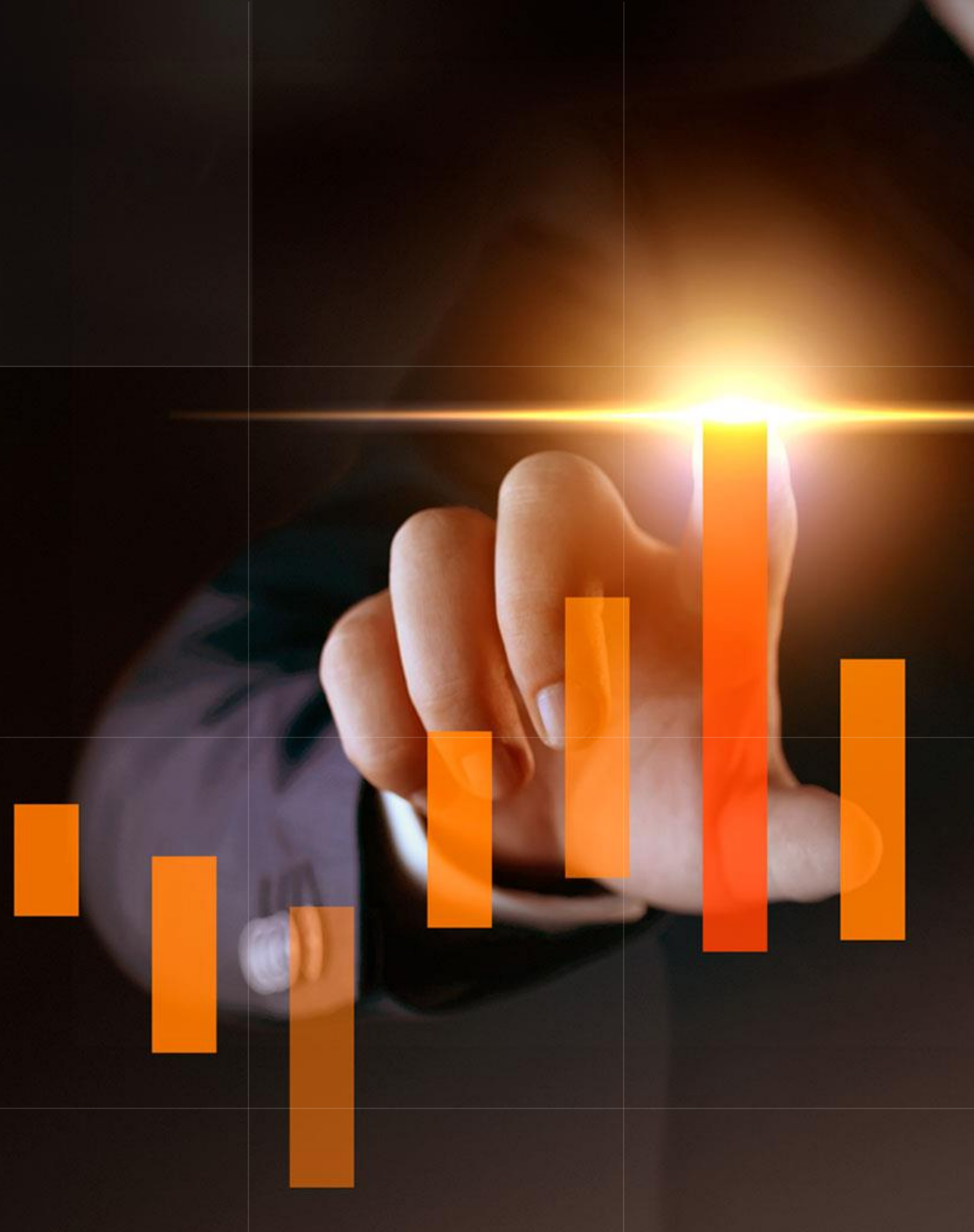
UK ‘mini’ budget

October 2022



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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Head of Capital Markets and Asset Allocation

Philip has over a decade of senior experience, much of that in currency and fixed income trading roles with the Reserve Bank of Australia (RBA) in both Sydney and New York, and as the RBA's representative on the G20 Investment and Infrastructure Working Group. Philip has also worked as a consultant to the World Bank in Washington DC and as an Economist at Macquarie Bank. Immediately prior to joining Frontier, Philip was the Economic Advisor to the Treasurer of the Northern Territory. Philip holds a Bachelor of Business (Honours) in Economics and Finance from RMIT, along with a Master of Public Administration (MPA) in Economic Policy Management from Columbia University in New York. He is also a CFA Charterholder.

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KC joined Frontier in 2012 and provides analytical support to clients, asset allocation advice, and investment research. KC is a member of Frontier's Capital Markets and Asset Allocation Team. Prior to Frontier, KC worked at Fairfax Media as the Head of Research and Valuation Analyst for BRW Magazine, he has also published business articles in print and online for Fairfax's various mastheads. KC interned in the Advisory division of PricewaterhouseCoopers. KC holds a Bachelor of Commerce, majoring in Accounting and Finance at Monash University with the Dean's Commendation. He also holds a Master of Applied Finance from Monash University. KC is a CFA Charterholder.

Executive Summary

Events in the UK may have further reverberations across global financial markets

On 23 September, the UK government announced a range of measures in a UK 'mini' budget. These measures represent a large deterioration in UK public finances and caused UK government bond yields to rise rapidly. The rise in bond yields was precipitated by selling of leveraged bond products, which culminated in the Bank of England intervening to buy UK government bonds.

Events in the UK highlight the difficult path policy-makers across the world may have in providing economic support in the face of a cyclical downturn and an environment of rising interest rates.

In the short-term there may be a possibility of some further reverberations in other financial markets as UK investors seek to raise capital to shore up their positions in leveraged UK fixed income markets. We are keeping a close eye for any market dislocations, as this may present opportunities for long-term investors.

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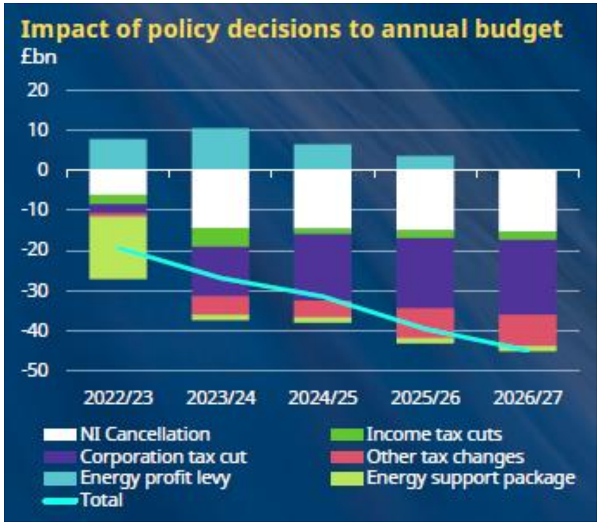
What happened

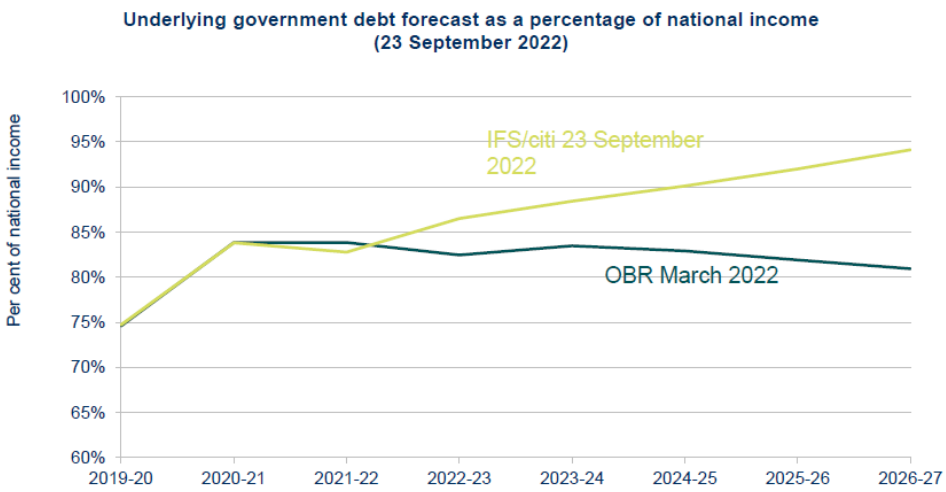
The not-so ‘mini’ budget saw the UK medium-term fiscal position deteriorate significantly

Medium-term fiscal impacts of mini budget



Source: Schroders, HM Treasury

Long-term fiscal impacts to debt-to-GDP



Source: IFS, LCP

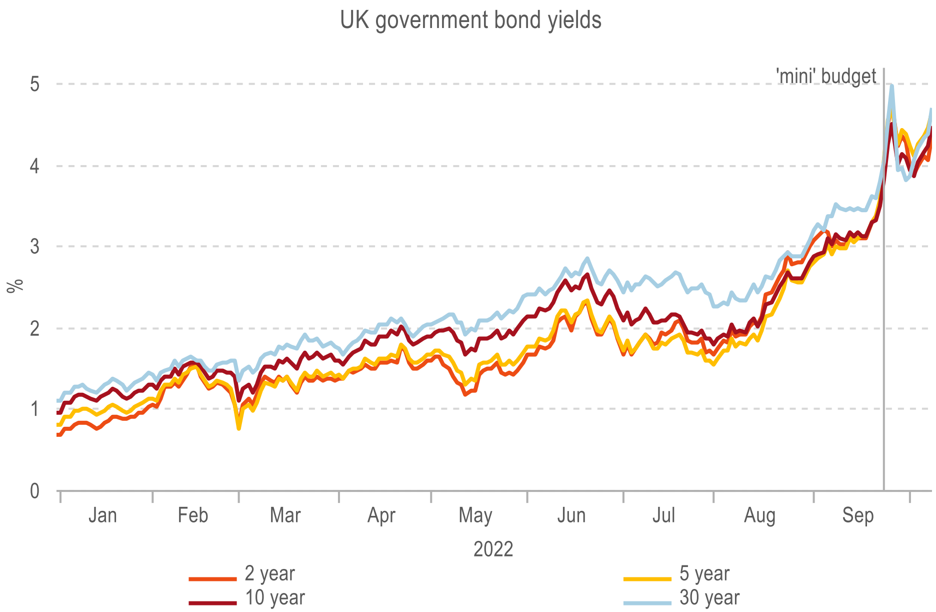
On 23 September, the UK Government announced a range of fiscal measures in a (now infamous) ‘mini budget’. The measures included one of the biggest net permanent tax cuts in UK history, at around 1.5% of GDP. This included a proposal to scrap the top income tax rate of 45 per cent, which has now been reversed.

Even without the top tax rate cuts, the overall budget package still represents a large deterioration in the UK’s fiscal position over the medium-term. Importantly for financial markets, the lack of specific measures on raising revenue meant long-term forecasts of public debt-to-GDP moved to a position of increasing debt at a time where inflation pressures are already high.

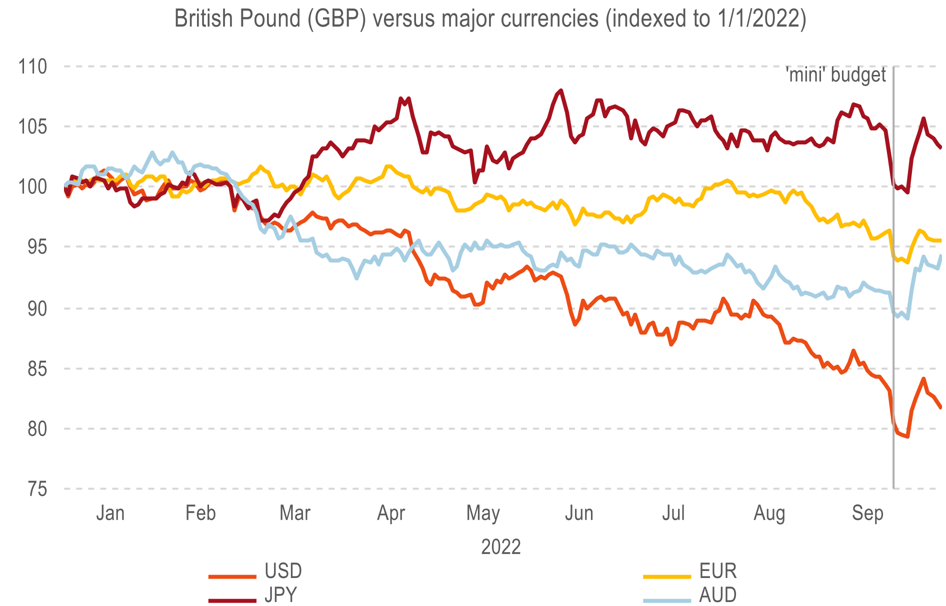
Frontier is in close contact with our UK-based Global Investment Research Alliance (GIRA) partner, Lane Clark & Peacock (LCP) in aiding with our understanding of how economic developments in the UK and Europe are unfolding.

How UK financial markets reacted

The deterioration in UK public finances caused UK borrowing rates to rise rapidly



Source: Refinitiv Datastream



Source: Refinitiv Datastream

Like other fixed income markets globally, UK bond yields have risen considerably since the beginning of this year as the Bank of England (BoE) and other central banks have begun rising policy rates in a move to combat a spike in global inflation. However, the move higher in yields of UK government bonds (also known as 'GILTs') accelerated higher in the days following the UK mini budget, as markets reassessed the deterioration in UK public finances.

The British pound (GBP) initially came under some pressure, continuing a move of depreciation in recent months. However, expectations of higher interest rates in the UK has meant the fallout in GBP has been relatively minor compared to GILTs.

The role of UK pension funds

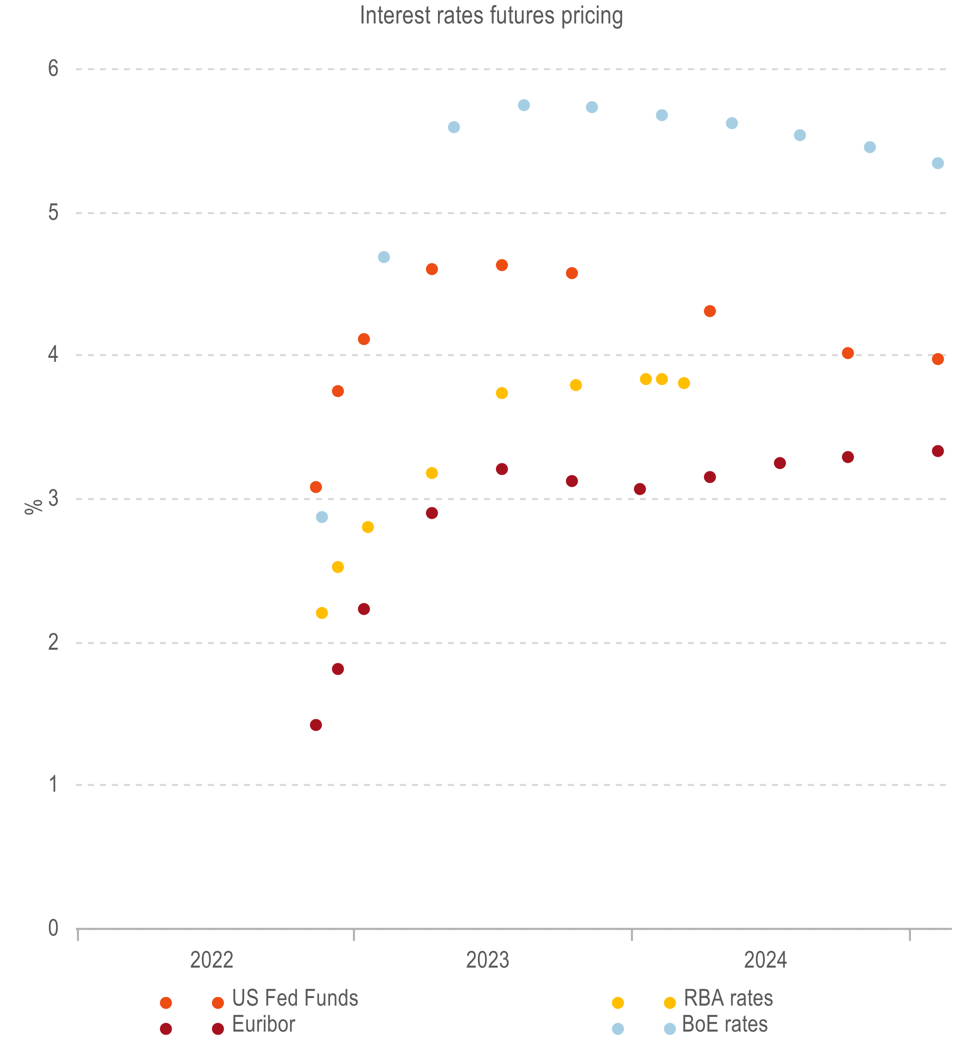
The use of leveraged bond products by UK-based investors magnified the moves

The move higher in UK government bond yields was magnified by the selling of leveraged fixed income products. Unlike in Australia, the UK pension system is dominated by defined benefit pension plans, which can have a much larger focus on asset-liability matching.

UK pension funds have used leveraged fixed income products as a way of gaining duration matched exposure to their liabilities. The appeal of these products to UK pension funds is that the use of leveraged fixed income products frees up capital that can be invested in other asset classes, like credit, equities and real assets.

However, the rise in UK bond yields (and fall in value of UK government bonds) meant these leveraged products were exposed to margin calls whereby capital was either needed or bonds sold. Given the move higher in bond yields happened so quickly, several of these funds were forced to sell bonds, which magnified the moves.

Ultimately, the Bank of England was forced to step in and buy UK government bonds to stop the upward spiral in yields. This program is expected to finish on 14 October. This is a reversal of a move by the Bank of England, which was on course to reduce its balance sheet following quantitative easing in the aftermath of the onset of the COVID-19 pandemic. The plan to begin reducing the size of its balance sheet ('quantitative tightening') has been postponed from the end of September to the end of October as a result.

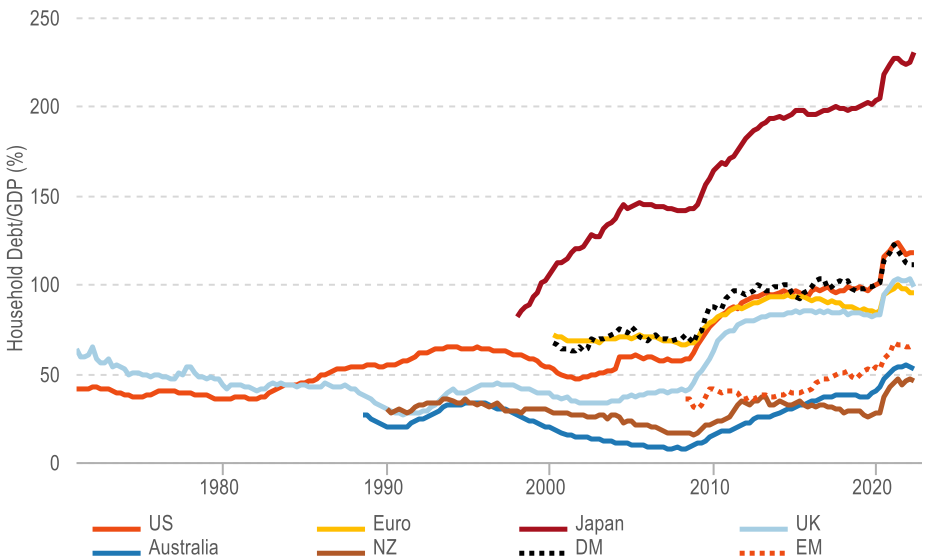


Source: Refinitiv Datastream

Macroeconomic ramifications

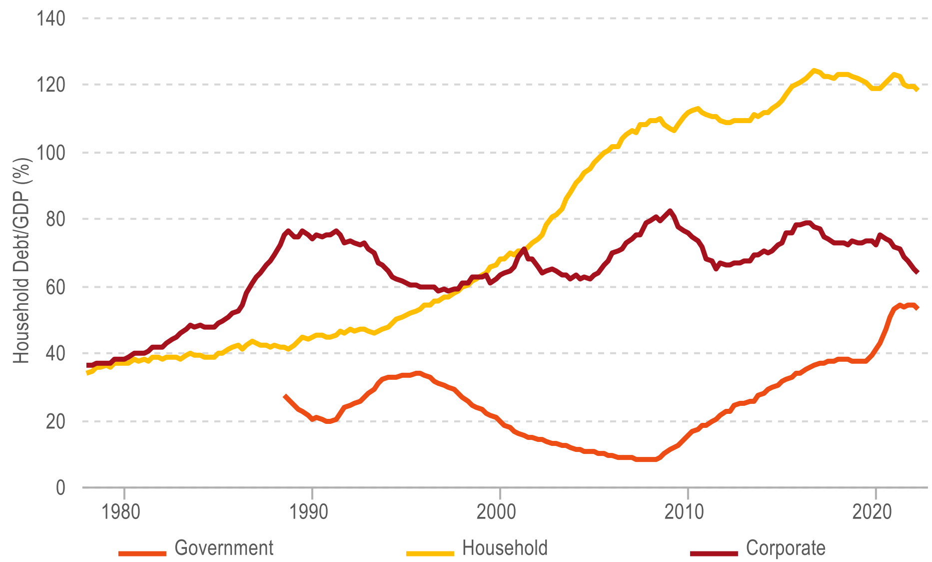
The UK situation, while unique, highlights the difficult path policy-makers tread facing a looming downturn

Government debt/GDP of key developed countries



Source: Refinitiv Datastream

Australia Debt/GDP



Source: Refinitiv Datastream

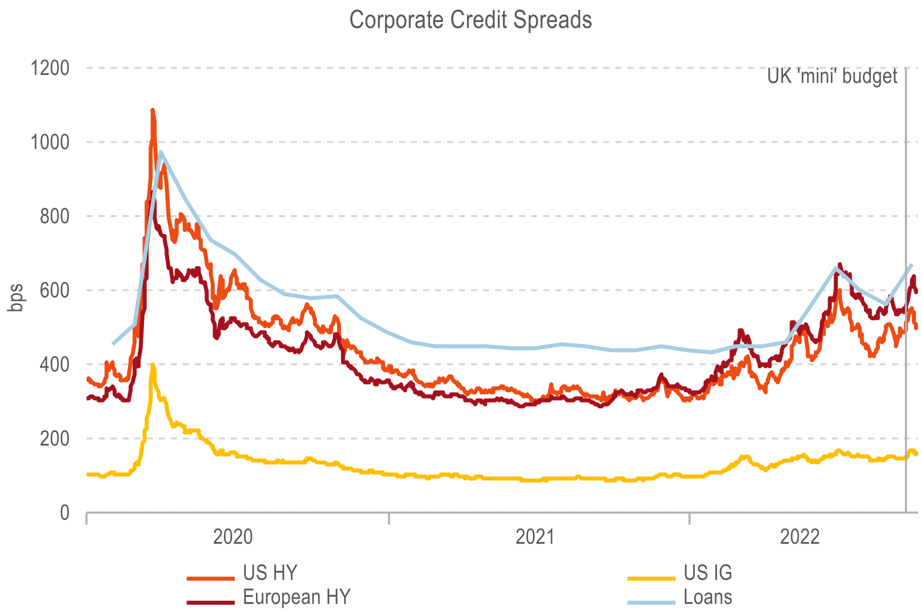
While the situation in the UK is unique, there are broader macroeconomic ramifications investors should be alert to.

First, the UK is not alone in considering how to provide stimulus in the face of an impending economic slowdown/recession. Governments across the world have seen public debt levels rise significantly following unprecedented fiscal support through the pandemic. The UK experience shows some countries may have limited policy space to provide stimulus in the event of a recession. In Australia, this effect is being highlighted by public commentary about future tax cuts given the expectation that the deterioration in the macroeconomic outlook will be shown and felt in the next federal budget.

For central banks, the UK's reverse course of 'quantitative tightening' is a reminder of the challenges to exiting the range of unconventional policy measures used since COVID-19. For example, in Australia the use of 'forward guidance' by the RBA to signal future cash rate increases during the COVID-19 crisis has now come under great scrutiny. This raises a question mark on how widely unconventional monetary policies will be used by central banks in future economic crisis events.

What we are watching

We are watching other markets, like credit and real assets, for any signs of risk and opportunities



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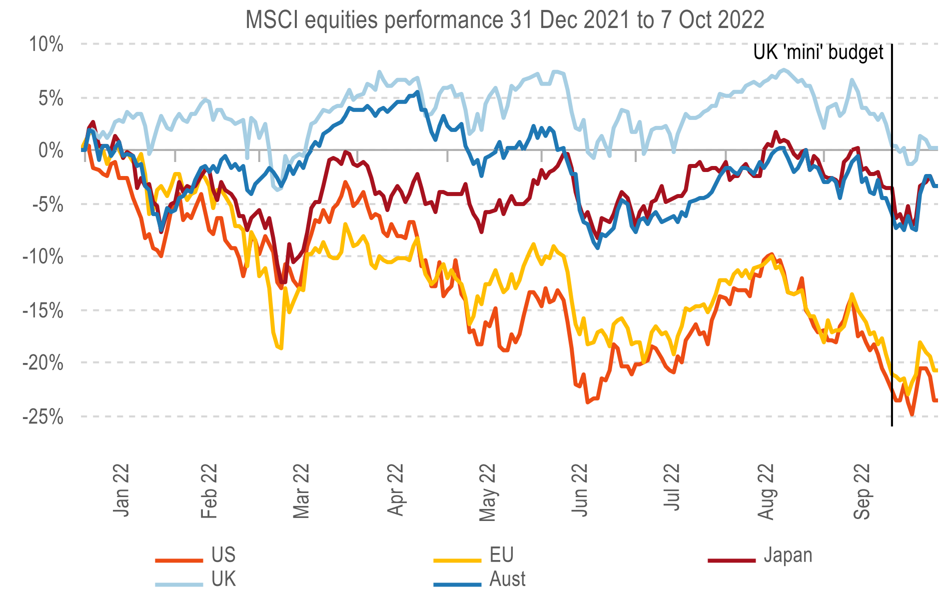

Source: Refinitiv Datastream

To recapitalise the leveraged UK bond funds, UK asset owners may need to sell down holdings in other assets to raise funds. This is likely to be the case in other liquid markets like credit and equities. However, it could extend to less liquid assets like infrastructure and property. Frontier is yet to see any significant outflows in open-ended property or infrastructure funds, although we are keeping in contact with market participants. While there have been some anecdotes of selling of Australian financial assets by UK investors, markets here and overseas remain to operate well.

We are watching markets closely not only for signs of risk, but also for opportunities as getting exposure to attractive investments remains a key medium-term asset allocation challenge for long-term investors. This is particularly true given we see a range of secular challenges facing investors, including the possibility inflation remains relatively high over the long run. We continue to believe, sometimes short-term volatility in financial markets can lead to opportunities for investors to buy assets with attractive long-term secular benefits.

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