4X Global Research

Olivier Desbarres ▌contact@4xgr.com ▌+44 (0) 20 3811 0454

Fixed Income Research & Macro Strategy (FIRMS) – 1st March 2021

Transitional UK budget unlikely to rattle markets

The British Chancellor of the Exchequer Rishi Sunak will on 3rd March, at around 12.30 UK time, present to the House of Commons the annual budget for the United Kingdom.

The ruling Conservative Party has a significant working majority of 87 seats in the lower house of parliament and we expect the budget to pass pretty smoothly.

While revenue and spending measures are very important for UK households and companies and the economy's medium-term direction, our historical analysis suggests that that financial markets' short-term reaction to the annual budget announcement is muted.

In the past six budgets the Sterling NEER has on average depreciated about 0.1% on budget day while the FTSE 100 has closed up about 0.3%. In the five trading sessions following the 2015-2018 budgets, the Sterling NEER was on average unchanged while the FTSE 100 on average only gained about 0.45%, with little variability. The only expectation to this pattern was the March 2020 budget but acute global risk aversion, rather than the UK budget, drove Sterling and the FTSE 100 weaker in our view. If anything the reaction of short-end Gilts to previous budget announcements has been even more tepid.

We see two inter-connected reasons for this. First, British governments in recent years have "pre-announced" most of their tax and spend measures to mainstream media, even if they often hold back a few vote-winning fiscal surprises to unveil on budget day.

Second, budget announcements contain such a wide array of tax and spend measures that gauging their short, medium and long-run impact on the economy, Sterling, Gilts or equity markets remains an exercise in faith as much as rigorous analysis.

This year's "two-pronged transitional" budget will be no different, in our view. Policies largely outside of the Chancellor's remit, including the pace of UK vaccination, will likely continue to be the main driver of domestic financial markets, including Sterling.

However, expect Sunak to confirm both a (temporary) extension of Covid-19 related fiscal measures to support the economy during lockdown as well as modest tax hikes regardless of the government's very low financing costs, in line with our September forecast.

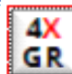
UK budget likely to pass with little difficulty but devil is in the detail

The British Chancellor of the Exchequer Rishi Sunak will on Wednesday 3rd March 2021, at around 12.30 UK time, present to the House of Commons the annual budget for the United Kingdom. The British government must seek parliamentary approval each fiscal year to continue collecting two major taxes – income tax and corporation tax[1]. It does this through the budget and ensuing finance bill (which effectively puts the budget into law). The budget is also used to announce new tax and welfare spending policies and gives an overview of the general state of the UK economy (the ruling party arguably uses this opportunity to highlight its economic successes while partly glossing over its failures, in our view).

Figure 1: Ruling Conservative Party's large parliamentary majority should ensure smooth passage of budget

Current composition of United Kingdom House of Commons (Lower House of Parliament)

Party	Seats	% of seats	Note
Conservatives	365	56.2	Majority ruling party. Includes two Deputy Speakers of the House who typically do not vote
Labour	200	30.8	Including one Deputy Speaker of the House who typically does not vote
Scottish National Party (SNP)	47	7.2	
Liberal Democrats	11	1.7	
Democratic Unionist Party (DUP)	8	1.2	Northern Ireland Party
Sinn Fein	7	1.1	Northern Ireland Party, typically abstains from voting
Independents	4	0.6	
Plaid Cymru	3	0.5	Welsh Party
Social Democratic & Labour Party	2	0.3	
Alliance	1	0.2	
Green Party	1	0.2	
Speaker of the house	1	0.2	Sir Lindsay Hoyle was formerly Labour MP but renounced his party affiliation upon his appointment and does not vote
Total	650		



Source: 4X Global Research, House of Commons

[1] Between 1998 and 2016 the government used to present the budget in March (Spring) just before the start of the new fiscal year, along with a Spending Review and Statement to Parliament in the Autumn. The government subsequently opted to hold the budget in the autumn (in 2017, a transitional year, the government presented both a Spring and Autumn budget). It then presented a single budget in the Autumn of 2018. The ruling Conservative Party decided to cancel the 2019 Autumn budge (the first calendar year in at least 100 years without a budget) as it would have coincided with an intra-term general election and instead held the budget on 11th March 2020. The government has this calendar year again stuck with a March budget, mainly so that it can update Covid-19 related fiscal measures.

In effect the lower house of parliament needs to vote in favour of the existing and proposed new tax measures with a simple majority. Some members of the Labour Party, by far the largest opposition party with 200 members of parliament, and of the ruling Conservative Party have threatened to vote against a budget which will in all likelihood introduce some tax increases (see below). However the ruling Conservative Party has 365 seats in the 650-seat House of Commons – a significant working majority of 87 seats[2] (see Figure 1) – and we therefore expect the budget to be passed.

At the risk of stating the obvious the revenue and spending measures contained in the budget are very important for UK households, including tax-payers, and UK-based companies (and indirectly to companies that deal with UK companies). They also shape the medium-term direction of the economy. Unsurprisingly there is in the weeks running up to the budget a great deal of focus on what the Chancellor of the Exchequer will announce and the implications at a household, regional, industry and economy-wide level.

Past six budgets point to Sterling's muted reaction to fiscal announcements…

However, recent history suggests that financial markets' short-term reaction to the annual budget announcement is reasonably muted. We see two inter-connected reasons for this.

First, there has been in recent years a growing tendency for British governments to "pre-announce" tax and spend measures, with mainstream media (including the BBC) being given advance notice of most of the Chancellor's specific plans (to be clear these are not unofficial leaks to the press). Successive governments have admittedly in the past held back a few fiscal measures to unveil on the day of the budget, usually "surprise" policies which are expected to go down well with voters across the political spectrum.

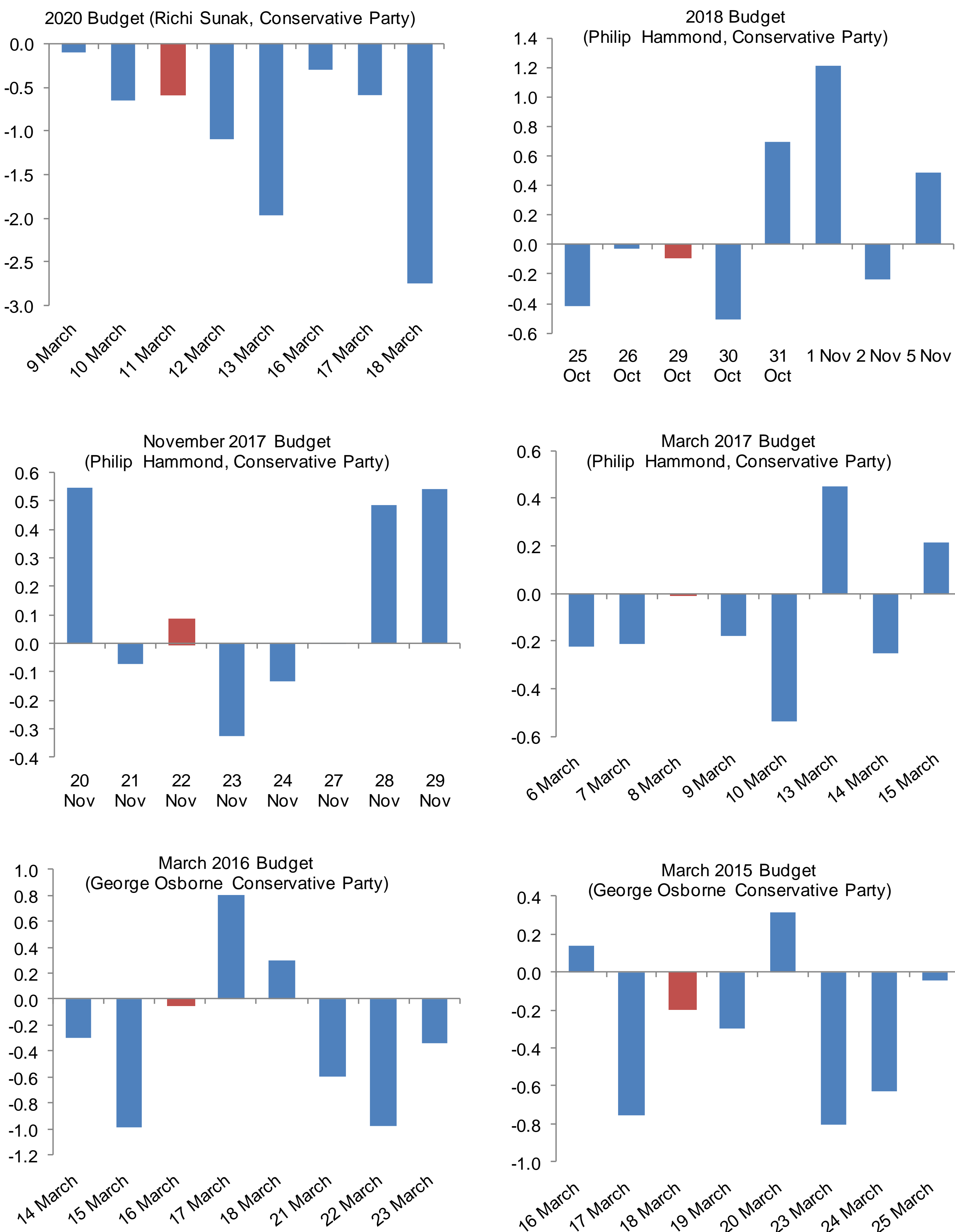
A generous interpretation is that governments have seemingly taken the view that gradually revealing budget measures ahead of the official announcement gives households and companies time to plan accordingly. A more cynical take is that, in a world dominated by social media, drip-feeding potentially "negative" policy measures (e.g. tax hikes and/or spending cuts), rather than announcing them all in one go on the day of the budget, is less politically-damaging and less likely to spook financial markets.

Second, the budget announcement – which typically lasts about an hour – contains such a wide array of tax and spend measures that it is often difficult for markets to ascertain with any certainty whether the budget will ultimately be positive or negative, in the short, medium and long-run for the economy, Sterling, Gilts or equity markets as a whole. While the media (and analysts) invariably tabulate the "winners" and "losers" of a budget – and sometimes these can be obvious – at an aggregate level the picture is rarely black-and-white in our view.

---

[2] The working majority is calculated as Conservative Members of Parliament (MPs) less all other parties but excluding MPs who typically do not vote in parliament. These are the Speaker of the House (who resigns from his/her party, at present the Labour Party), the three Deputy Speakers (currently two Conservative, one Labour) who do not resign from their parties and the seven Sinn Fein MPs who do not sit in Parliament as they do not recognise its legitimacy. So 363 (365 minus 2) minus 276 (285 minus 2 minus 7) equates to an 87-seat government majority.

Figure 2: % change in Sterling Nominal Effective Exchange Rate. Red bar denotes day of the budget

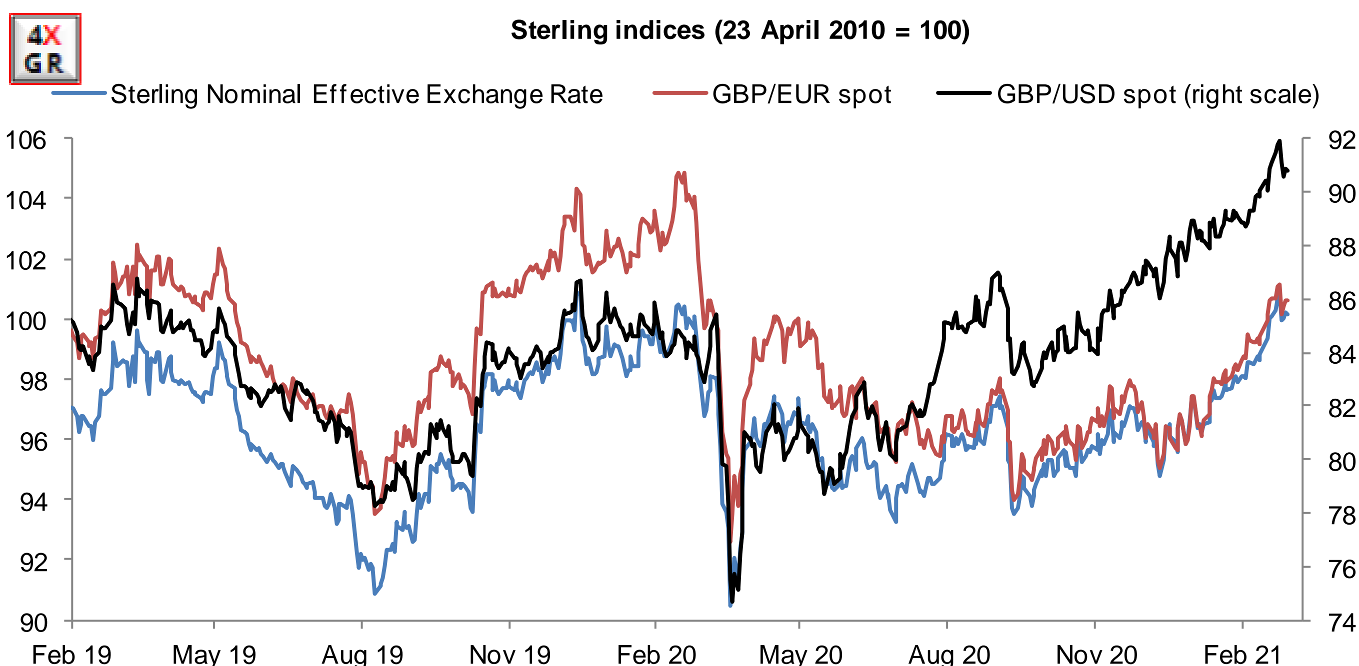


Source: 4X Global Research, Bank of England, investing.com; Note: Name in bracket is Chancellor of the Exchequer's

Figure 2 shows how Sterling behaved before, during and immediately after the past six budget announcements[1]. On budget day the Sterling Nominal Effective Exchange Rate (NEER) – a trade-weighted average[3] of Sterling against the currencies of the UK's main trading partners – has tended to move little. On average it has depreciated about 0.1% according to our estimates. The largest move (a 0.6% sell-off) was recorded on the 11th March 2020 budget. However, Sterling had been weakening in the run-up to the budget and weakened further in subsequent days, which we attribute to the impact of the slump in global risk appetite on the more risk-sensitive Sterling, rather than to the budget per se (see Figure 3).

In the five trading sessions following the five other budgets, the Sterling NEER was on average unchanged. On a daily basis it appreciated by on average about 0.3% and 0.1% respectively, following the 29th October 2018 and 22nd November 2017 budgets and depreciated about 0.1%, 0.2% and 0.3%, respectively, following the 8th March 2017, 16th March 2016 and 18th March 2015 budgets.

Figure 3: Sterling (and FTSE 100) weakened around March 2020 budget but global risk aversion likely cause



Source: 4X Global Research, Bank of England, investing.com

…and it is a similar story for the FTSE 100 and short-end Gilts

It is a not too dissimilar story when we assess the performance of the FTSE 100 before, during and after the past six budget announcements. On budget day, the FTSE 100 has on average closed up about 0.3% according to our estimates (see Figure 4). The only slightly notable performance was the FTSE's 1.6% rally on 18th March 2015. It closed broadly unchanged in the two 2017 budgets and closed up

[3] We use Bank of England trade-weights

a modest 0.6% on 16th March 2016. The FTSE 100 did close up 1.3% on 29th October 2018 but this only reversed the 0.9% loss recorded in the previous session while, as we argue above, the 1.4% sell-off on 11th March 2020 had more to do with an acute slump in global sentiment than with Rishi Sunak's budget announcement. The FTSE 100 dropped about 13.5% in the following five sessions.

Moreover, in the five trading sessions following the five other budgets, the FTSE 100 on average only gained about 0.45%, with little variability. It closed higher on four occasions: on 5th November 2018 (+1.1%), 25th March 2015 (+0.7%), on 15th March 2017 (+0.5%) and on 23rd March 2016 (+0.4%). It closed lower on 29th November 2017 by a modest 0.3%.

If anything the reaction of UK short-end Gilts to previous budget announcements has been even more muted. Figure 5 shows the basis point change in 2-year government bond yields pre and post budget. On budget day, 2-year Gilt yields on average fell only 1.5 bps according to our estimates. They were broadly unchanged on 11th March 2020 and 29th October 2018 and fell only very marginally in the 2016 and 2017 budgets. Only on 18th March 2015 did Gilt yields move significantly, falling just over 5bps. In none of the past six budgets can we discern a clear or significant pattern of performance in the five trading sessions which followed the budget announcement.

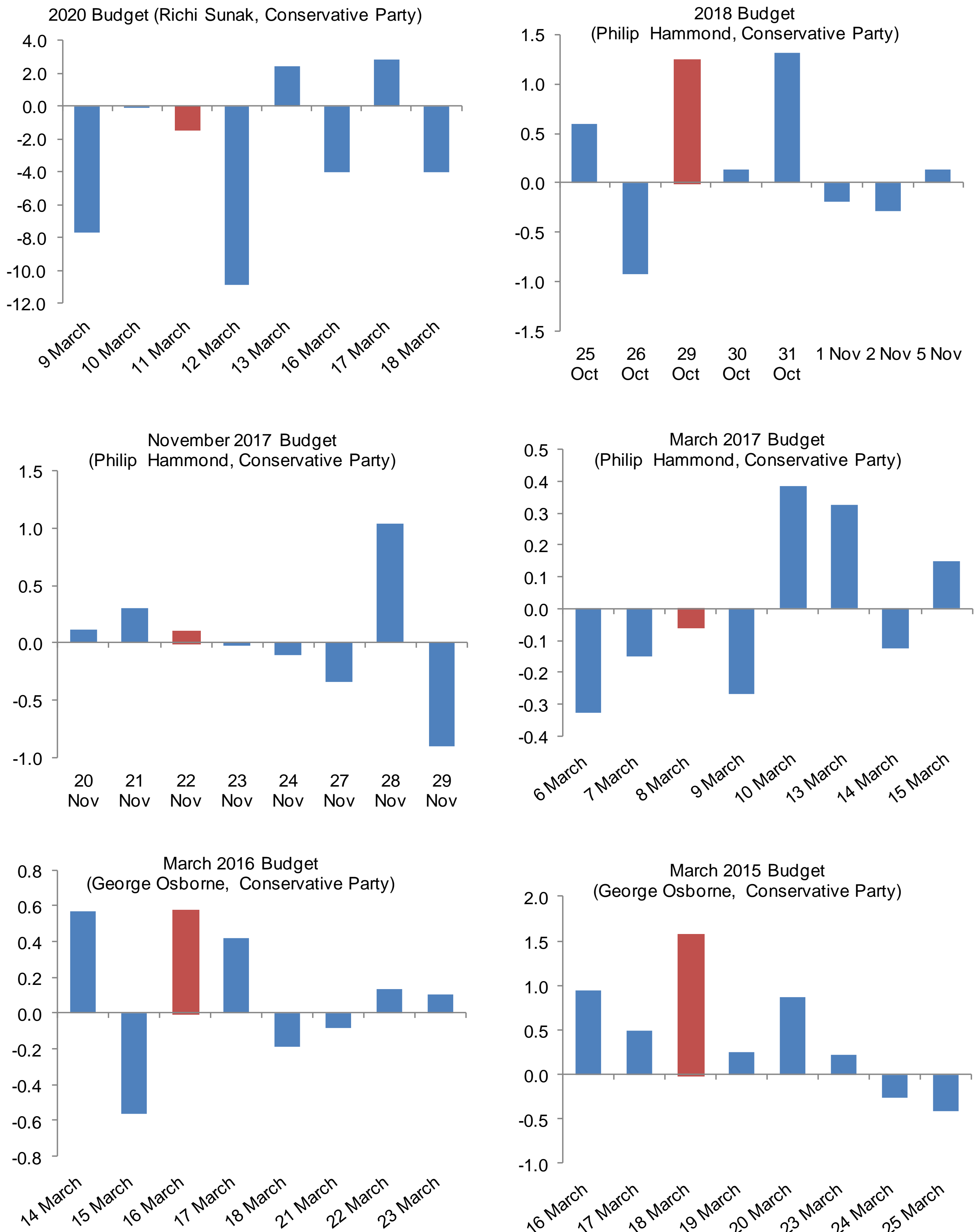
Financial markets unlikely to react much to pre-announced "transitional" budget

We do not think that financial markets' reaction to Wednesday's budget will be very different and see no obvious reason to expect material changes in either Sterling, the FTSE 100 or UK Gilts. As in past budgets the Chancellor may well announce a few unexpected, "positive" policies which could very briefly bring financial markets to life. However, the still gargantuan cost to the government of Covid-19 related fiscal measures will limit Sunak's scope to deliver costly surprises, in our view. Ultimately we think that policies largely outside of the Chancellor's remit, including the pace of vaccination in the United Kingdom, will likely continue to be the main driver of domestic financial markets, including Sterling, in the short and medium-term.

In many ways Wednesday's budget can be seen as a two-pronged "transitional" budget, in our view, based on already announced fiscal measures.

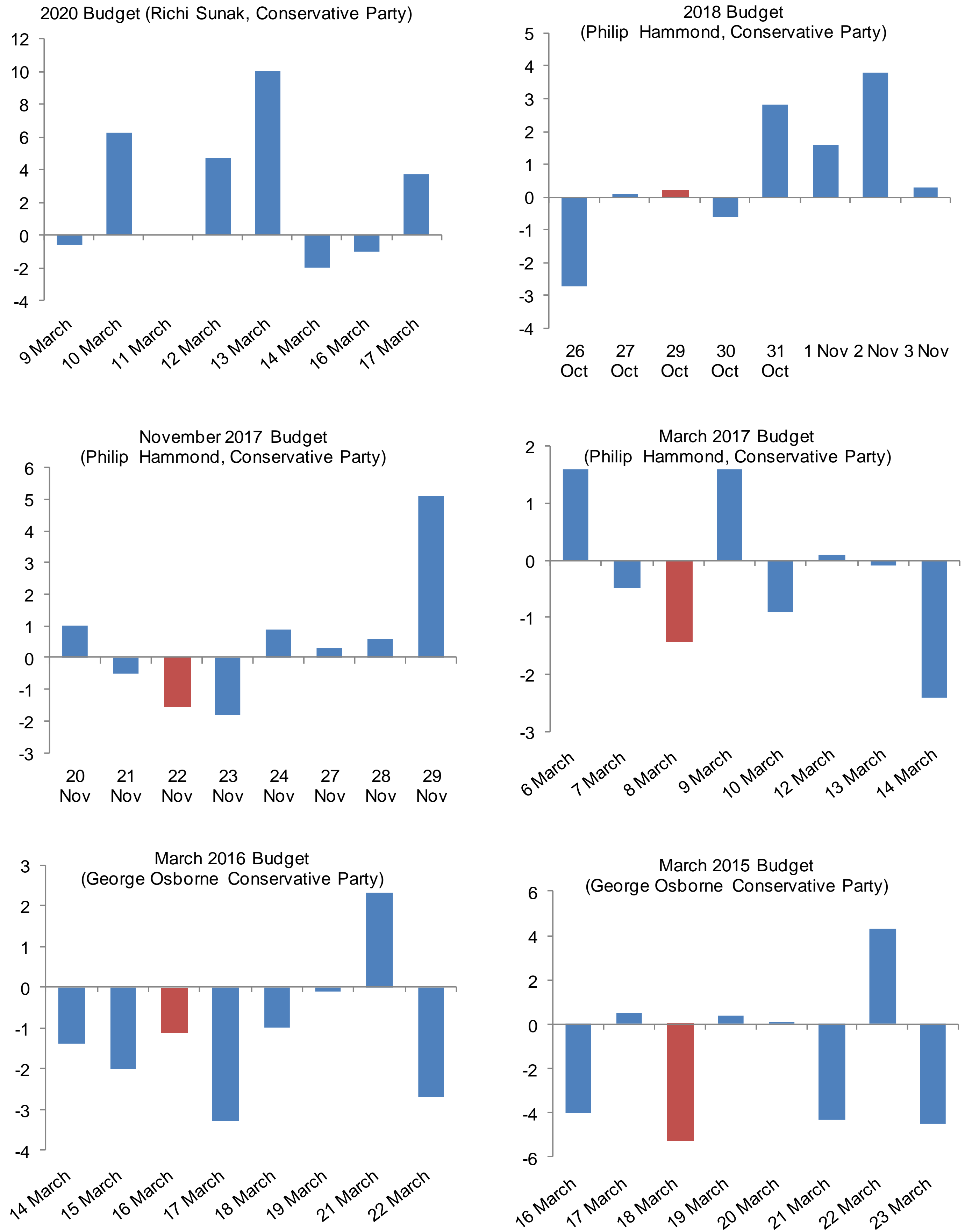
Sunak will on the one hand extend Covid-19 measures to support over the next few months British households, corporates and ultimately an economy still stifled by a strict national lockdown. On the other hand Sunak will also likely introduce a first round of modest tax hikes, on the expectation that the lockdown will start being gradually eased from April onwards and in a bid to stabilise and eventually slowly start shrinking the record-high budget deficit and public debt. This would be in line with our September forecast that "*the economy faces a potential quadruple whammy in coming months of fiscal stimulus measures being unwound, […] and higher taxes*" (see UK & Sterling facing potential quadruple whammy, 4th September 2020).

Figure 4: % change in FTSE 100. Red bar denotes day of the budget



Source: 4X Global Research, investing.com; Note: Name in bracket is Chancellor of the Exchequer's

Figure 5: Change in 2-year government bond yield (basis points). Red bar denotes day of the budget

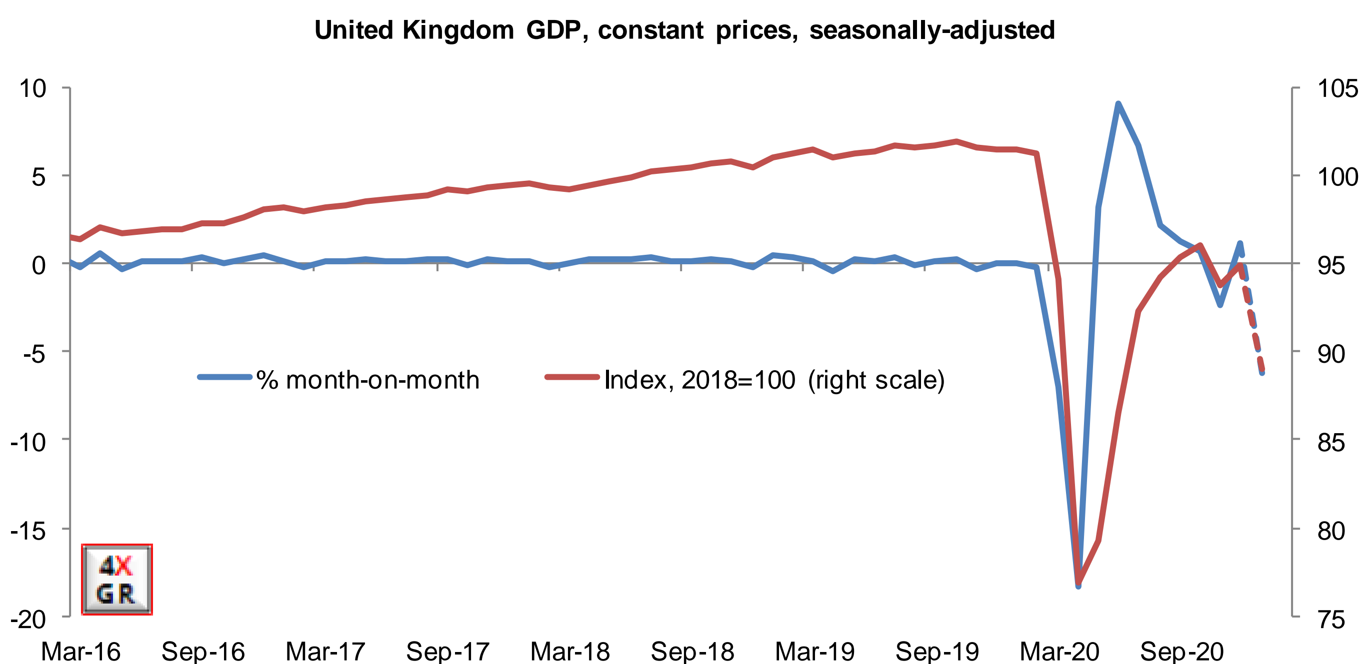


Source: 4X Global Research, investing.com; Note: Name in bracket is Chancellor of the Exchequer's

There is a prevailing argument across the political spectrum that Sunak should not be raising taxes at this point in the economic cycle, even modestly, as the UK economy is still very weak. Indeed Figure 6 shows that in December 2020 the UK GDP was 6.5% lower than a year prior and GDP is likely to have contracted further in January, in our view, as the domestic economy was still in full lockdown.

There is a second, related argument that Sunak does not need to raise taxes because the government is effectively borrowing from itself at near zero cost. Indeed the Bank of England has financed the entirety of the government's deficit through its vast Quantitative Easing program by buying up government-issued bonds. Moreover, government yields in the secondary market are very low across the maturity spectrum so the government could in theory sell its bonds into the market and pay a negligible interest rate. Put differently the government's interest payments are so low as to make the size of the fiscal deficit and public debt almost irrelevant, at least near-term.

Figure 6: UK GDP in December was still 6.5% lower than in December 2019 so is it right time to hike taxes?



Source: 4X Global Research, ONS

Note: Last data point is 4X Global Research forecast for January 2021

However, this ignores two factors which we think Sunak feels compelled to take into account. First, the Bank of England may not be willing to increase the size of its QE program for ever and if the government was forced to finance its deficit by issuing Gilts to the market, yields and thus the government's debt-servicing costs could rise, potentially materially.

Second, and perhaps more importantly in the near-term, we think Sunak is in part being driven by the negative "optics" of a Conservative government, which prides itself on fiscal rectitude, running a persistently very high budget deficit and presiding over a debt-to-GDP ratio over 100%. The Office of Budget Responsibility (OBR) forecast in November that Public Sector Net Borrowing (effectively the budget deficit) will hit a post-war high of 19% of GDP in the fiscal year ending 31st March 2021 while government debt breached the £2 trillion mark for the first time ever this summer. Put differently, we think that Sunak and ultimately the government are taking the view that ultra-loose fiscal policy was justified during the height of the Covid-19 pandemic but will be increasingly unacceptable to the Conservative Party's core voters as the economy recovers.

For these twin reasons we are sticking to our long-held view that Sunak will in two days time start putting in place the foundations of more prudent fiscal policy and that UK tax rates will be slowly raised further in subsequent annual budgets.

DISCLAIMER & DISCLOSURE STATEMENT

THIS MATERIAL IS: (I) FOR YOUR PRIVATE INFORMATION, AND WE ARE NOT SOLICITING ANY ACTION BASED UPON IT; (II) NOT TO BE CONSTRUED AS AN OFFER OR A SOLICITATION OF AN OFFER TO BUY OR SELL ANY SECURITY IN ANY JURISDICTION WHERE SUCH OFFER OR SOLICITATION WOULD BE ILLEGAL; AND (III) BASED UPON INFORMATION THAT WE CONSIDER RELIABLE.

4X GLOBAL RESEARCH DOES NOT WARRANT OR REPRESENT THAT THE PUBLICATION IS ACCURATE, COMPLETE, RELIABLE, FIT FOR ANY PARTICULAR PURPOSE OR MERCHANTABLE AND DOES NOT ACCEPT LIABILITY FOR ANY ACT (OR DECISION NOT TO ACT) RESULTING FROM THE USE OF THIS PUBLICATION AND RELATED DATA. TO THE MAXIMUM EXTENT PERMISSIBLE ALL WARRANTIES AND OTHER ASSURANCES BY 4X GLOBAL RESEARCH ARE HEREBY EXCLUDED AND 4X GLOBAL RESEARCH SHALL HAVE NO LIABILITY FOR THE USE, MISUSE, OR DISTRIBUTION OF THIS INFORMATION.

The analysis and information presented in this report (Report) by 4X Global Research Ltd (4X Global Research), an independent research company registered in the UK, is offered for subscriber interest only. The content is intended for investment professionals only, and is not to be viewed or used by individual investors in any regulatory jurisdiction. By accessing this Report you confirm that you meet these criteria.

This Report is not to be used or considered as a recommendation to buy, hold or sell any securities or other financial instruments and does not constitute an investment recommendation or investment advice. The information contained in this Report has been compiled by 4X Global Research from various public and industry sources that we believe to be reliable; no representation or warranty, expressed or implied is made by 4X Global Research, its affiliates or any other person as to the accuracy or completeness of the information. 4X Global Research is not responsible for any errors in or omissions to such information, or for any consequences that may result from the use of such information. Such information is provided with the expectation that it will be read as part of a wider investment analysis and this Report should not be relied upon on a stand-alone basis. Past performance should not be taken as an indication or guarantee of future performance; we make no representation or warranty regarding future performance. The opinions expressed in this Report reflect the judgment of 4X Global Research as of the date hereof and are subject to change without notice.

This Report is not, and should not be construed as, an offer or the solicitation of an offer to buy or sell any securities. The offer and sale of securities are regulated generally in various jurisdictions, particularly the manner in which securities may be offered and sold to residents of a particular country or jurisdiction. Securities referenced in this Report may not be eligible for sale in some jurisdictions. To the fullest extent provided by law, neither 4X Global Research nor any of its affiliates, nor any other person accepts any liability whatsoever for any direct or consequential loss, including without limitation, or lost profits arising from any use of this Report or the information contained herein.

No director, officer or employee of 4X Global Research is on the board of directors of any company referenced herein and no one at any such referenced company is on the board of directors of 4X Global Research. 4X Global Research does not invest in any securities although it is possible that one or more of 4X Global Research's directors, officers, employees or consultants may at times be invested in the securities referenced.

4X Global Research is not authorized or regulated in the United Kingdom by the Financial Conduct Authority (FCA) or by any other regulator in any jurisdiction for the provision of investment advice. Specific professional financial and investment advice should be sought from your stockbroker, bank manager, solicitor, accountant or other independent professional adviser authorized pursuant to the Financial Services and Markets Act 2000 if you are resident in the United Kingdom or, if not, another appropriately qualified independent financial adviser who specializes in advising on the acquisition of shares and other securities before any investment is undertaken.

This Report, including the text and graphics, is subject to copyright protection under English law and, through international treaties, other countries. No part of the contents or materials available in this Report may be reproduced, licensed, sold, hired, published, transmitted, modified, adapted, publicly displayed, broadcast or otherwise made available in any way without 4X Global Research's prior written permission. All rights reserved. This document is produced using open sources believed to be reliable. However, their accuracy and completeness cannot be guaranteed. The statements and opinions herein were formed after due and careful consideration for use as information for the purposes of investment. The opinions contained herein are subject to change without notice. The use of any information contained in this document shall be at the sole discretion and risk of the user. Investors should consider this report as only a single factor in making their investment decision and, as such, the report should not be viewed as identifying or suggesting all risks, direct or indirect, that may be associated with any investment decision.

No liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the recipient acting on such information or opinion or estimates. 4X Global Research employees may have or take positions in the markets and securities mentioned in this document. The stated price of any securities mentioned herein is not a representation that any transaction can be effected at this price. Investing in securities may entail certain risks. The securities referred to are not suitable for all investors and should not be relied upon in substitution for the exercise of independent judgment. This material is not directed at you if 4X Global Research is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. 4X Global Research and its analysts are remunerated for providing independent investment research to financial institutions, corporations, and governments.

DISCLOSURE: This Report is not to be copied, forwarded or otherwise disseminated to non-subscribers in electronic or physical form without prior consent.