InvestmentUpdate

16 March 2023

Budget 2023: small steps into big headwinds

The Budget contained some useful measures to address key challenges facing the UK economy, but doesn't fundamentally change the tough outlook

The changes announced in the Budget sensibly target several key challenges facing the UK economy. The chaos of last year's 'mini-budget' now feels like a distant memory. However, Chancellor Jeremy Hunt's plans represent only small steps given the scale of the macroeconomic headwinds – reinforced by the storm clouds building over Credit Suisse, a major global bank, as he spoke.

Despite the fiscal watchdog's forecast that recession will be narrowly avoided in 2023, we believe it is still the most likely scenario. And much more needs to be done to combat constraints on the UK's long-term economic potential.

Cost-of-living help, but recession still on the cards

The Chancellor announced a few measures designed to limit the cost-of-living squeeze on households. He committed to maintaining the energy price guarantee at £2,500 for a typical household for three further months from April, rather than letting it rise to £3,000. He also scrapped a planned increase in fuel duty and offered some relief on alcohol duties.

These measures should help at the margin, but they aren't large enough to move the needle much. The outlook for the UK consumer still looks difficult. Energy bills will remain exceptionally high for a while, with the typical household paying more than twice as much as in mid-2021. Meanwhile, the effects of last year's interest rate increases continue to feed through. More than 1.4 million UK households need to refinance fixed-rate mortgages this year. Over half of them were previously paying rates below 2%, compared with the 5.1% average currently offered by lenders, so monthly payments will rise sharply. The proportion of households facing very high debt repayments relative to their incomes is likely to jump this year.

As if that wasn't enough, the global economic backdrop continues to get tougher. The failure of tech lender Silicon Valley Bank in the US last week has been followed by severe pressure on the much larger Credit Suisse, which regulators deem a 'global systemically important bank'.

It is encouraging that policymakers have been swift to step in and provide liquidity, with the Federal Reserve announcing a new facility to help US banks and Switzerland's central bank lending directly to support Credit Suisse. It's also important to note that the largest banks globally are much better capitalised now than they were ahead of the global financial crisis, giving them much greater capacity to absorb losses. And we don't see the evidence of widespread lending to borrowers with poor credit quality, or broader credit bubbles, that we did then. There hasn't been the same surge in private credit relative to the size of the economy, for example. We will communicate further on this as the situation unfolds.

Even if swift policy action quells the acute strains on banks that we're seeing now, though, lenders around the world are likely to turn more cautious regardless. Banks began tightening lending standards significantly late last year, and that will only continue in light of recent events, contributing to more economic weakness across the globe.

This all informs our overall cautious positioning. With recession risk high in the UK and other advanced economies, we're keeping equity exposure in our portfolios lower than usual. Within our equity exposure, we're focusing strongly on defensive sectors – those that typically hold up best in a downturn, like utilities, healthcare and consumer staples – over their more cyclical counterparts.

More work to do on the UK's structural constraints

The Chancellor's "Budget for Growth" also had an eye on the long term, targeting a couple of key structural constraints holding back the UK economy that we've flagged up before, namely labour supply and weak investment. In both cases, it's encouraging to see politicians acknowledge the problem. But the measures announced at the Budget alone will fall well short of fixing them.

To get people back into the labour force, Hunt announced a raft of measures including: a £5 billion childcare plan (comprising expanding free childcare in England, aiming to boost the number of childminders and more); changes to the benefits system; and scrapping the pension lifetime allowance (aiming to discourage professionals, particularly senior doctors, from taking early retirement).

To give a sense of scale, the number of people aged 16-64 in the labour force has fallen by more than 300,000 since the start of the pandemic. The independent Office for Budgetary

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Responsibility (the fiscal watchdog) estimates the changes announced at the Budget will together increase employment by only 110,000 in four years' time, and many of those will not be full-time workers.

It's also worth adding that childcare shortages and early retirement are minor issues compared to the one big factor keeping people out of work: the alarming rise in long-term sickness linked to the continuing strain on the NHS. As health service waiting times have climbed, over 400,000 16–64-year-olds have left the labour force due to long-term health problems, more than offsetting the number joining for other reasons. Addressing the state of the health service is vital to getting people back to work.

Otherwise, the Chancellor aimed to promote business investment, replacing the expiring "super deduction" with a 100% capital allowance. This allows businesses to write off investment in new plant and machinery against their taxable profits.

Again, seeking to address this issue makes a lot of sense. UK investment has been weak for years and adjusting for inflation it is lower now than it was in the mid-2010s. But the biggest factor holding back investment has, in our view, been constant uncertainty over trade policy. Investment in the UK kept pace with its peers in the first half of the 2010s. It wasn't until the Brexit referendum that the UK fell decisively behind, as the sands of UK-EU relations have constantly shifted since. The Windsor framework agreed in February should help on this front, but after so much flux it may take time to convince businesses that we've reached a sustainable equilibrium.

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