Equity Research; New PM will rise to the challenge

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

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PM Rishi Sunak > Chancellor Rishi Sunak

The departing PM left with a broad smile, devoting her speech to justifying her plan for lower taxes to magically provide GDP growth. Barely a word on the mess this caused. Her ability to ostrich away surging mortgage rates, crashing gilts, evaporating pensions, Bank of England bailouts was astonishing. What happened in this bizarre 6.5 week period?

Liz Truss's car crash radio and TV interviews were 'Wizard of Oz' moments when the curtain gets pulled back and stark reality is revealed. It is rare that PMs are so nakedly exposed. Truss hurt the UK's reputation and willingness to hold sterling denominated assets. This unhappy period aptly demonstrated populism's failure. Truss got to the top by making grandiose tax cut promises that many wanted to believe. Her mistake was believing her own populist hype. The problem is the UK cannot afford tax cuts. Investors were expecting a £10bn-£15bn borrowing requirement but were presented with £72bn.

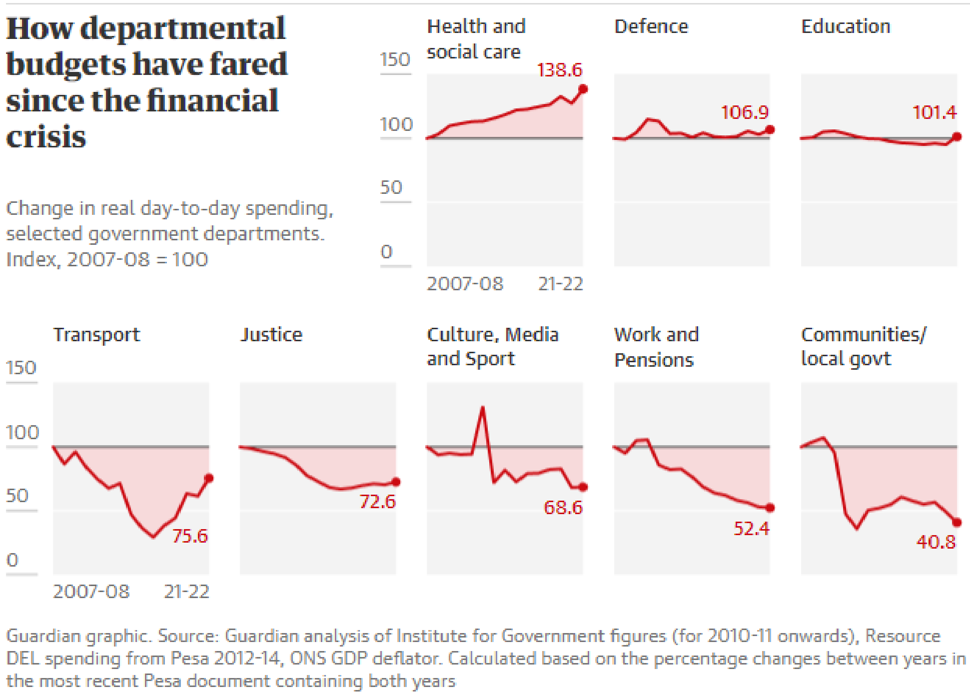
PM Rishi Sunak's first task is to restore confidence amongst international investors and creditors that the UK is willing and able to take tough decisions, not dine out on soft options. Sunak starts in the right place with a track record of economic competence including the successful rollout of the furlough programme in 2020. To restore 'financial stability" means a properly functioning gilt market. The first step will be an economic policy that in broadly in tune with the Bank of England's inflationary commitment, i.e. one that rebalances onto spending caution/ austerity. To achieve this PM Sunak needs to get the UK's fiscal framework right.

We expect that the new PM will rely on his core economic credentials and will build on his image as an economic problem fixer. He will want to take some major steps to reduce the UK budget deficit. He will be quick to make decisions i.e. get rid of bad ideas. The re-imposition of the fracking ban is one early example of this.

a) The Fiscal Framework

The Chancellor's decision to delay the medium-term fiscal plan to 17th November 2022 should be interpreted as providing time for the PM and Chancellor to consider tax increases and spending cuts. The new Chancellor had said no options were 'off the table' when it comes to addressing the £40bn 'black hole' in public finances highlighted by the Institute of Fiscal Studies. Both Sunak and Hunt had to back track and re-commit to an increase in defence spending to 3% by 2030.

The challenge on UK government spending, as usual, is the fact that given 45% of the UK government budget is the NHS, a 'sacred cow' where savings are impossible, the focus tends to fall elsewhere. However other UK departments have been cut back substantially already as demonstrated below.



source; the Guardian 25th October 2022

In our view the scope to cut UK spending considerably depends on taking tough decisions on the 'triple lock', the possible deferment of the state pension age and benefit changes.

On the revenue side there could be higher corporation taxes and 'windfall' taxes on specific sectors notably banking. As Chancellor, Sunak had introduced 'windfall' 25% tax on oil & gas company profits with an allowance for investments which attracted tax relief at 90%. Sunak had also started the process for evaluating windfall taxes on power companies and how they might work. The idea of more extensive windfall taxes on a one-off basis might be helpful if they do not prompt a corporate exodus, which appears unlikely given geopolitical tensions.

A windfall tax on the banking sector could raise between £6bn-£8bn in FY23.

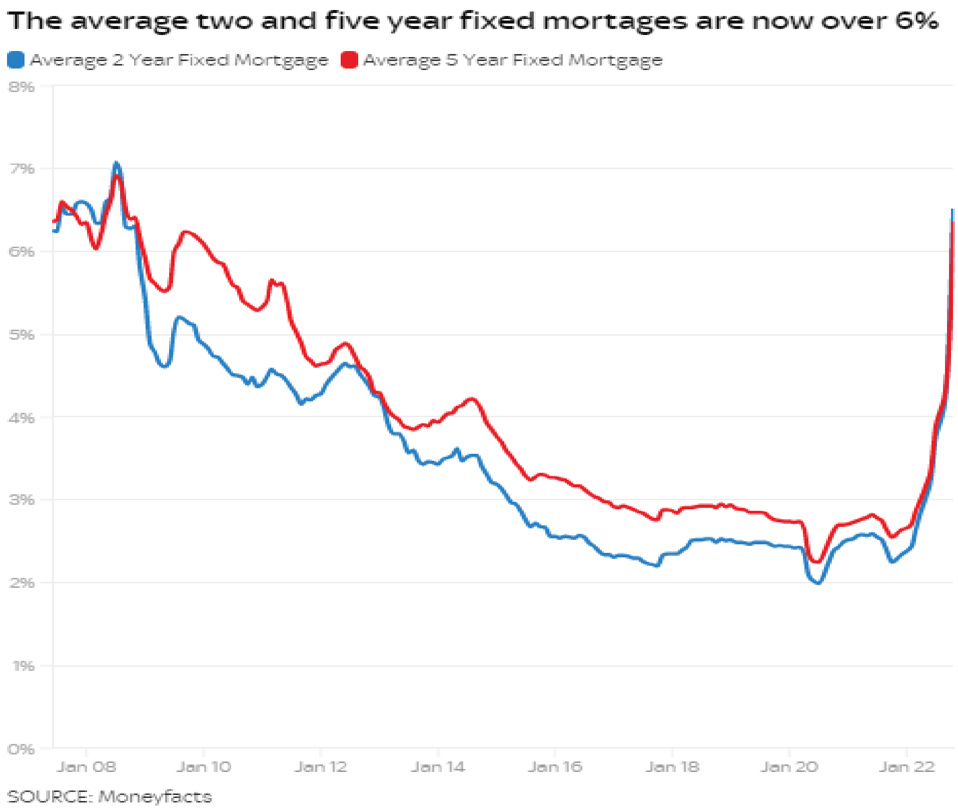
Other 'major' Budget tools that could be employed:-

a) VAT changes - a 1% increase would raise c. £6.2bn – this would be politically unpopular, however its impact might be masked by the inflationary surge
b) Increasing the National Insurance rate for employers by 1% would raise c. £6bn and could be on the agenda
c) A further review of the UK's overseas aid commitments

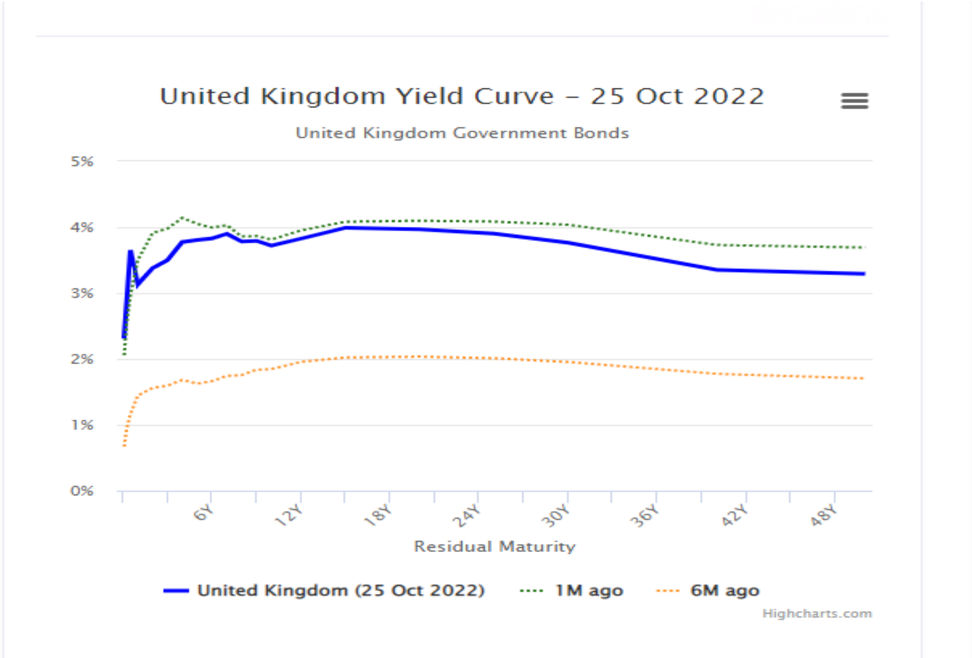
b) Mortgages

A key goal is to get mortgage rates back to affordable levels before further damage is done to the UK consumer/ property industry (c.16% of GDP).

The problem is the rolling expiry of mortgage hedges. Approx 300k mortgages per month are coming off cheap rate fixes. At current fixes the increase is c. 4% in extra interest that could prove disastrous for at-risk households. As the graph below shows, 2022 gains are the sharpest on record.



Windfall taxes on the banking sector will not lower mortgage rates. Should the yield curve continue to move lower, mortgage rates should pull back to c. 5%. This will still be painful for borrowers, and rapidly slow property activity.



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Since the scrapping of the mortgage affordability 'stress test' on the 1st August 2022, the Bank has confirmed that another rule, that limits new mortgage lending to 4.5x the borrower's income was staying in place. However if this rule was temporarily relaxed, and this is a big 'if' that could provide help given current conditions which have been described as having almost stopped.

'Cometh the moment, cometh the man'

With PM Rishi Sunak in place, can investors breathe a sigh of relief? Yes

a) Liquidity – recent events were a national 'stress' test that demonstrated the UK's strengths and fragilities. Equity investors are used to holding their noses, and being sacrificial lambs, but on this occasion too many groups, got hurt too quickly. Pensioners are now in the clear, but mortgagees still need rescuing. As liquidity conditions normalize, rate expectations have abated from 5.5% mid 2023 – we think rates will peak at 4.25% in H1 2023 with mortgages near 5%.
b) Inflation – PM Sunak and Chancellor Hunt are likely to keep the BoE mandate and independence intact providing support and encouragement to the BoE to get monetary policy right.
c) A return to Osbourne austerity – will the UK face rolling multi-year austerity measures? No – in our view PM Sunak wants to deliver the fiscal medicine early, given the 2025 election cycle. Some major sacrificial cuts in government spending is likely soon.
d) Tax rises- yes we expect higher taxes on middle income (£30k-£60k) and higher income brackets and on employers national insurance.
e) ISAs and SIPPs – we do not expect changes to the structure of either.
f) Equity indices – the UK equity market has held up well given the complexities and geopolitical problems of 2022 - the near 1,000 point drop at its worst point over September arguably marked a short term trough. For a sustained rally some success on inflation and a calming of tensions is pre-requisite. But at least now the UK can move off the front page of the international press. Confidence has been restored. The UK has proved that when leadership goes wrong, its a problem can and will be fixed.

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