

Changing Fiscal Policy – Austerity to Spendthrift

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In the long slow recovery from the great financial crisis, the conduct of monetary policy has all but eclipsed fiscal policy in the major economies. By fiscal policy, we mean changes by government to the general level of taxation and the government's own spending.

Prior to 2008, almost all postwar recessions had been rectified, at least, in part, by a rise in government spending to replace lost private demand. That standard Keynesian response to a depressed economy was not followed after 2010. George Osborne, the then Chancellor of the Exchequer, along with other finance ministers around the world, focussed on deficit reduction i.e. reducing government spending in what became known as “austerity.”

Monetary policy or the level of interest rates became the sole tool of so-called “macro-economic stabilisation.” Whatever the impact on the broad economy, a matter which will provide thesis material for a generation of doctoral economics students, the impact on asset prices and share prices was electric.

As interest rates fell, the fall in the discount rate explains why equity prices surged even in the absence of a strong profits recovery. Put simply, a lower discount rate, as a function of the maths, raises the present value of a stream of periodic payments; dividends, for example. (The converse is also true which is why markets intensely dislike rising interest rates).

So, investors have been well rewarded, even as growth has been anaemic.

To put it mildly, rather a lot has happened in the UK in the last few months. For investors, it would appear, risks have risen markedly. But hidden in the depths of the Brexit debate, there is perhaps a scrap of good news. Fiscal austerity is quietly being replaced with fiscal activism.

The new Prime Minister has been making spending commitments with almost comic abandon. So far, Mr Johnson has earmarked £1bn for the police, £5bn for schools, an income tax reduction amounting to £9bn a year and a £3.6bn fund for “left behind towns.” The Northern Powerhouse idea has been reborn with a £39bn commitment for a Liverpool, Manchester, Hull high-speed railway.

Interestingly, the shadow chancellor of the exchequer, John McDonnell, has promised to match these spending commitments. Thus, in his first days as PM, Mr Johnson has completely recast government spending plans; no doubt there will be more announcements to come.

What does this mean for investors? Firstly, fiscal expansion would normally turbo-charge profits growth. Secondly, fears of a hard Brexit have driven the pound to multi-year lows benefitting UK Plc earnings. Thirdly, the absence of inflationary pressures means that the Governor of the Bank of England can continue to maintain easy monetary policy i.e. low interest rates. Fourthly, at some point, when Sterling stabilises, UK assets will look extremely cheap to overseas investors. Everything has a price, even political instability.

Earlier this year, we increased our weighting to UK equities based on historically low valuations and on the expectation that this fiscal expansion would at some point take place. We have been partly rewarded for this as one of our largest holdings which we re-introduced into the Real Return Strategy – the Finsbury growth and income trust, has rallied by 25% year to date. However, our other UK holdings remain deeply undervalued. Low valuations, a cheap Sterling and increased fiscal spending remains the catalyst for increased returns going forward.

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