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Market Reaction to the UK's Fiscal Event

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UK financial markets have reacted extremely badly to the "fiscal event" launched by Kwasi Kwarteng, the new Chancellor of the Exchequer. Every British financial asset has slumped: equities, gilts, and the external value of the pound. House prices look vulnerable to a sharp rise in mortgage rates as the Bank of England debates how to respond to the elevated borrowing plans of the Chancellor. That itself is damaging, as many commentators look to the Bank for decisive action.

The dilemma confronting markets is the conflict between the fiscal policy remit of the Chancellor, and the independent remit of the Bank of England's monetary policy. The Bank of England is combatting rising inflation, whilst the Chancellor is risking pouring cash into a supply-constrained economy with unfunded tax cuts, making the problem worse. The Bank wants to dampen down excess demand in a supply constrained economy through interest rates without causing a recession, but the Chancellor is using fiscal loosening to stimulate demand in a "dash for growth" in a way that will likely result in continues price rises.

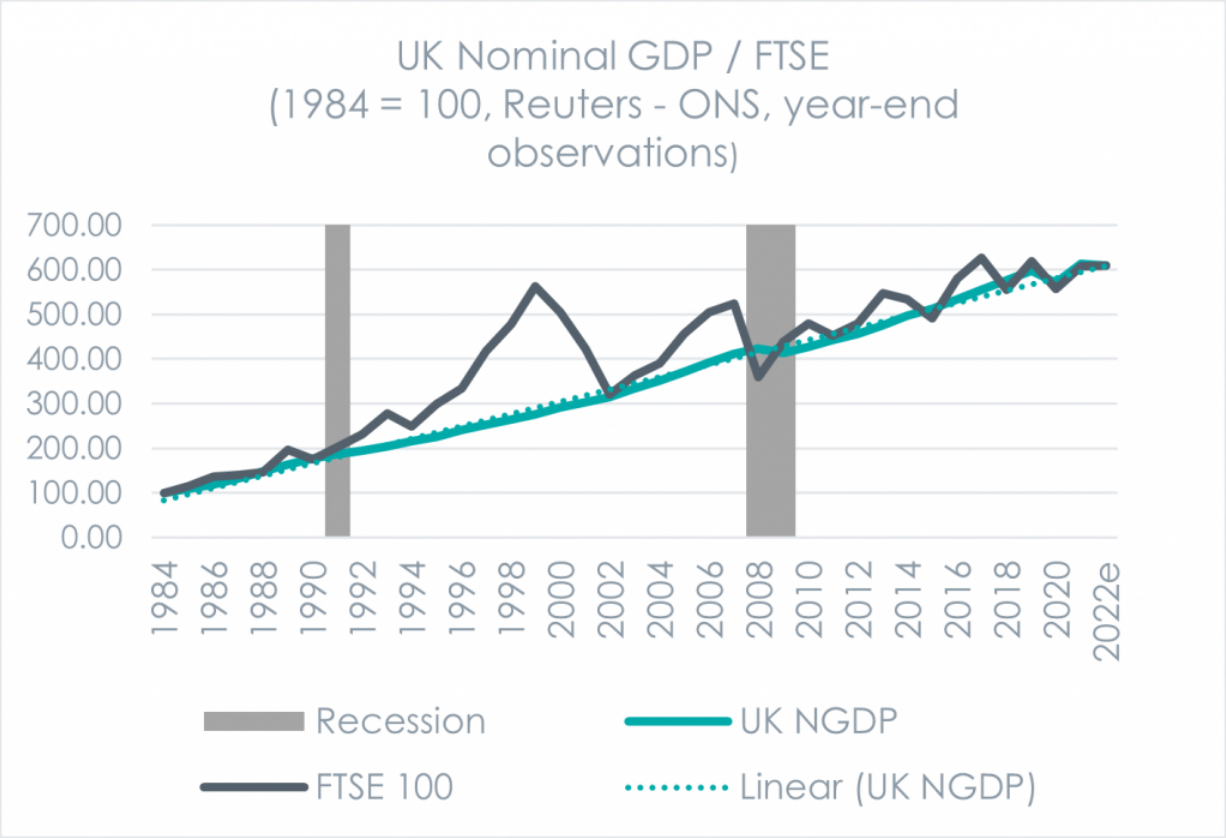
As a consequence, to this conflict, the market's reaction was a loss in confidence in the UK economy, with asset prices across the board falling sharply. Market volatility is naturally uncomfortable; however, our job as long-term investors is to try and make sense of this and to look beyond the immediate turmoil and journalistic headlines.

The Bank of England, along with much of the rest of the world after the Great Financial Crisis wanted to see higher inflation, but inflation caused by rising demand in an improving global economy, not the supply side inflation caused by the exogenous shock of war. Price deflation, the kind we saw after the financial crash of 2008, is more dangerous than controlled inflation and can lead, as it did in the 1930s, to Depression.

The second and most important point is that "everything has a price."

The UK is not an "emerging economy" as some have suggested recently. It remains one of the world's highest income economies. The UK borrows in its own currency and is not about to default. Indeed, although the UK debt burden is high, it is lower than much of the rest of the world's high-income economies: the G7.

What is true is that the adjustment to higher market interest rates that we expected to happen over 2 or 3 years has happened in the space of a week. That is a shock that markets must price but, as so often in the past, they can overshoot. In time, market interest rates will stabilise and the flow of international trade to the UK will resume, not least because many UK assets are now cheaper and more attractive to overseas investors. The Bank of England response this week was due to the pace of change in the long-term gilt yield rather than the level. It is important to note this.



Source: Tacit Investment Management. FTSE 100 and UK Nominal GDP from 3rd January 1984 to 29th September 2022, retrieved from Reuters.

The chart above illustrates the progress of the FTSE 100, which was established in 1984, against the progress of UK GDP over the same period. You would expect the two series to have a clear relationship since the corporate sector is largely responsible for generating GDP (the production measure of GDP).

The deviations between the two lines are a consequence of the valuation investors give to shares at any point in time. The underlying economic activity doesn't vary very much but the prices that investors pay for that activity varies enormously.

You can see very clearly that UK shares were hugely overvalued during the early dot.com era of the 1990s (it took 20 years for that overvaluation to erode), and again in 2008 just prior to the financial crash of 2009.

No such obvious overvaluation exists today, and indeed, many investors have complained that UK shares have lagged their overseas counterparts. Moreover, when UK shares trade through GDP, it has been a compelling buying opportunity.

The message to our clients is that yes, the policy and economic outlook is difficult and uncertain in the short term, but as with all crises, it will pass.

Our approach to managing portfolios through this phase of the investment cycle and particularly through 2022, has been to shorten the duration of return expectations and increase the quality of cashflows in both our Stabiliser and Growth Asset components of portfolios. For some time, our Stabiliser allocations were focused on fixed income securities that had shorter maturities to protect and minimise the effects of changes in inflation and interest rate expectations. Within the growth component, our equity allocations have been focused on companies with strong and growing cashflows, solid balance sheets and most importantly lower valuations that provide some ballast to portfolios through the current volatility. It is not a coincidence that the majority of these are based overseas, benefiting from the strength of the US Dollar against all other major trading currencies.

Today, from a US dollar perspective, leading UK companies look exceptionally cheap. Not only has share price performance lagged but one dollar now buys 93.7p rather than the 69p that it bought a year ago. To a US investor, UK assets are 1/3rd cheaper than they were only a year ago. How this value is unlocked can be through higher share prices

as investors' confidence returns and they invest in UK equites. When the dust settles, we would expect to see a sharp revival of cross-border merger and acquisition activity. Everything has a price and sometimes that price can be too cheap to ignore.

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