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Market Update – Budget Reaction

The Rise of Rishi

While there have been few winners from the pandemic, politically speaking one of those to benefit has been Rishi Sunak, who has risen from little known junior minister to Boris Johnson's heir-apparent. Over the course of the last 18 months he has authorised a huge expansion in the state, with unprecedent support for both businesses and workers. Chancellors aren't typically the ones who celebrate such spending, however, and throughout 2021 Mr Sunak has shown that this largesse goes against his nature. Wednesday's budget therefore was an opportunity to set a course back towards fiscal prudence. Faced with an economy that is still fragile, with rising inflation and a party seeking to distance itself from austerity, a sudden move towards lower government spending would have been a shock and hence further investment was the main theme of the budget. Yet with his pledge to ensure that day-to-day spending is fully funded through taxation and that debt falls as a percentage of GDP (national economic output) within three years, the Chancellor has signalled his desired direction.

Few Surprises

Within the announcements for immediate policy changes there were a number of positives for the economy, such as investment in transport infrastructure (a long term gain) and the temporary reduction in business rates for hospitality and retail businesses (a quick boost following the hurt of the pandemic). Pubs were also clear beneficiaries with the simplification of alcohol duty – shares in this sector rallied after the announcements. Yet, overall there were no changes which were perceived as having a major impact on the path of the economy. Consequently market movements were subdued in general, with one major exception.

All Else Not Equal

The price of government bonds (gilts) surged throughout Budget day, as more optimistic growth figures came from the Office for Budget Responsibility and as the Debt Management Office predicted lower public borrowing demands. This suggests that the government will need to issue less government debt both this year and into the future. As basic supply and demand theory tells us, as supply of an asset shrinks, its price will rise, all else equal. On this basis, the rally in price for government bonds (and therefore the fall in long term interest rates this creates) is justified. Where this seems odd, however, is that over the medium term, all else will not be equal. Through quantitative easing, the Bank of England is the largest purchaser of UK government bonds and it fulfils this role in order to stop long term interest rates rising too high. Yet, as the economy recovers, the Bank of England, along with central banks across the developed world, is set to taper its quantitative easing programme, meaning it will buy fewer government bonds over the coming years. As such, while government bond prices rallied with the budget, over the medium to longer term, this trend is unlikely to continue and prices are more likely to fall again as the Bank of England retreats from the market.

Interest Rates

Moving on from long term interest rates, and from the budget, and market attention is likely to quickly turn to short term interest rates. Given the higher inflation we are witnessing and the economic progress made since the depths of covid, interest rates are likely to be increased over the coming months, with the first rise possible next week as the Bank of England's Monetary Policy Committee meets. Regardless of whether a rise does occur so quickly, or whether it is delayed for a brief period, the direction of travel is clear.

Housing Market

This is already being reflected in the mortgage market, with banks removing the most generous of offers over recent days. With the housing market experiencing a boom over the past year, a cooling effect from higher interest rates may be no bad thing. A reduction of stimulus for the rest of the economy may also be desirable if it is able to restrict inflation from rising higher.

A Balancing Act

Risk is present, however, with a rising interest rate a likely brake on economic output. Markets are therefore primed. If the degree of rate rises cools an overheating economy, without derailing it, then we're on track for a protracted period of balanced expansion. Yet if rates go too high, and a policy mistake is judged to have occurred, then the hard earned recovery could be squandered. This debate has been present for a number of months now and when markets have been in a positive mood, we have seen higher long term bond yields and strength in more cyclical equities, yet the opposite has also occurred. Consequently volatility in investment markets is likely to persist over the coming months, as the movements of the Bank of England and its overseas peers are closely scrutinised.

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