The Weekly Round-up

10 January 2025

In our latest weekly round-up, Guy Foster, Chief Strategist, discusses whether the UK chancellor is having a 'Liz Truss moment', and if UK taxes will rise again.

Is this a moment?

We may never know whether former Prime Minister Liz Truss was thinking "this is my moment" while her chancellor delivered the government's growth plan (known colloquially as the mini-budget) to the House of Commons. It has, however, been known ever since as the 'Liz Truss moment' and has become shorthand for markets dumping a country's assets in protest of an unsustainable tax and spending plan.

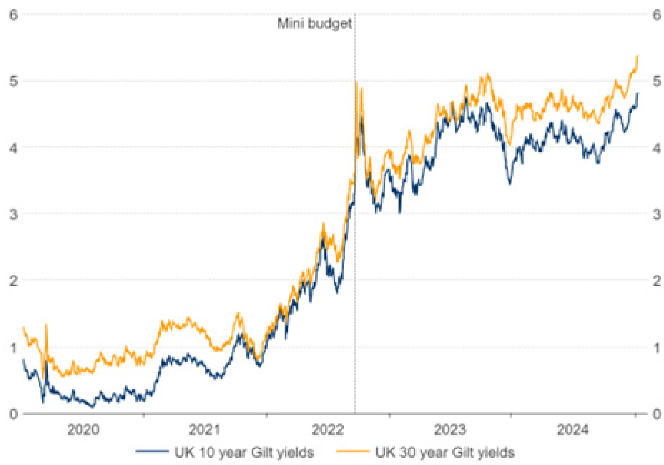
'Liz Truss moment' ranks alongside 'Lehman Brothers moment' as a descriptor of a severe market reaction. But perhaps it bears more in common with the more dramatically named 'Black Wednesday,' which the UK suffered in 1992 when it was forced to devalue the pound and leave the European Exchange Rate Mechanism (ERM).

In that instance, the Bank of England (BoE) was charged with maintaining the pound's level within a 6% band against other members of the ERM. The band was too high for the UK, and as the pound started to slide out of it, the BoE was charged with buying sterling to bolster it. The central bank couldn't, however, hold back a tidal wave of speculative flows betting that the pound would eventually be allowed to fall. Inevitably, it eventually did.

In doing so, many argue, the markets caused a devaluation that enabled the UK economy to emerge from recession, which the government's misguided exchange rate policy may have prevented.

The all-powerful market

The similarity between that event and Liz Truss and Kwasi Kwarteng's mini-budget was that the market showed itself to be more powerful and influential than the government. This is something that has always fascinated me, and that motivated Bill Clinton's political adviser James Carville's famous quote: "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."



Source: LSEG Datastream

The bond market, in these instances, is sometimes referred to as a group of bond vigilantes; individuals who enforce the law despite having no authority to do so. They differ, of course, from true vigilantes, who would be motivated by civic duty. This is because bond vigilantes are motivated by self-interest alone, with occasional policy improvements being a happy consequence rather than an objective.

Is this a 'Liz Truss moment'?

That was then, this is now. After the mini-budget, UK ten-year borrowing costs reached 4.5%; they are 4.8% now. So, is Chancellor Rachel Reeves now having her 'Liz Truss moment'?

The most obvious similarities are the adjacency to a budget, and the unusual phenomenon of a falling currency more-or-less coinciding with rising bond yields (which would normally attract foreign bond buyers).

The last UK budget was the end of October. In it, the chancellor, who had criticised Truss for having crashed the economy with a debt-fuelled tax-cutting programme, announced a debt and tax-fuelled spending programme. It was poorly received by the market, although the dominant emotion was probably disappointment rather than shock.

Here was a former BoE economist, who had been the shadow chancellor of the exchequer for three years. Reeves came with the endorsement of former Bank of England Governor Mark Carney and had committed to not raise taxes on working people. So, a budget that delivered a big increase in borrowing, and a big increase in employment taxes was very underwhelming.

However, it was less shocking because Reeves had at least allowed scrutiny by the Office for Budget Responsibility (OBR), and there was some recognition that she was facing an almost impossible task (improving public services whilst maintaining any semblance of fiscal credibility).

Therefore, there wasn't the same dramatic reaction as to the Truss budget, but borrowing costs have risen and now eclipse those seen during the crisis. A lot of that reflects rising yields globally, particularly since the U.S. election. In fact, the degree to which the UK stands out is small but significant.

Why is the UK in the crosshairs?

There are a few possible reasons. It could reflect the UK's higher inflation during 2022/3, although in truth it wasn't much worse than the Eurozone. The UK's budget deficit is wide relative to many developed economies, but not the U.S. or France, whose bonds have been less weak. Wage growth has been more persistent in the UK than in the U.S., which makes it harder for the BoE to cut interest rates.

It may partly reflect the political system and budget process in the UK. As the government has an enormous majority, it's in a much stronger position to pursue a tax and spend policy if it desires. Other countries tend to see protracted periods of negotiation amongst different parties, allowing the markets to absorb and respond to proposed spending increases more gradually.

It could be argued that the Labour government is faced with relatively few institutional constraints due to its parliamentary majority. However, political and market constraints remain. Ensuring the market gains or regains confidence in the government is a function of maintaining the right rhetoric. The Treasury stated on Wednesday that, "no one should be under any doubt that meeting the fiscal rules is non-negotiable and the government will have an iron grip on the public finances". Then it needs to ensure that actions follow that rhetoric.

The chancellor has set fiscal rules that, at current interest rates, she seems on course to break. Therefore, she may need to consider government spending cuts or tax increases if interest rates don't drop by March when the next OBR forecasts are prepared.

Will UK taxes be rising again?

Whether UK taxes will be raised depends on a few factors.

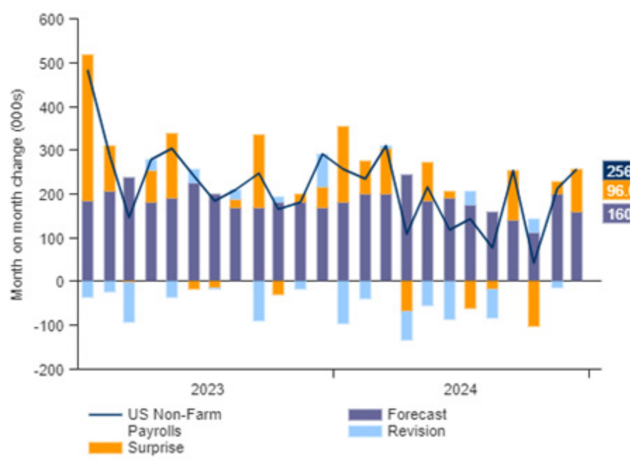
The most obvious is the outlook for the UK economy. If the economy remains strong, interest rates will remain high, and the government's headroom will be diminished. If the economy were very weak, welfare payments would increase. Ideally, continued positive growth with an ebbing of inflation is needed.

In the UK, a rise in government bond yields has a fairly direct impact on the economy. It means that swap rates, and therefore mortgage rates, are likely to continue to increase, which is a headwind for housing market activity. The outlook for house prices has been quite strong in recent months, so it's unlikely we'll see price declines – but as mortgage rates creep up and affordability becomes more stretched, there must be some impact on housing market momentum.

Jobs growth is also expected to be weaker because of last year's increase in employment taxes. If the current trend of weaker jobs growth continues, the BoE will be more willing to cut interest rates and bond yields will decline accordingly. A slowdown in wage growth would be particularly beneficial, as this has been the Achilles heel of the UK economy.

And beyond the UK?

There are external factors to consider here as well. If OPEC (the Organisation of the Petroleum Exporting Countries) countered the increase in U.S. oil production with a price war, inflationary concerns would ebb away quite quickly, but that doesn't currently seem to be on the cards.



Source: LSEG Datastre

Another external factor would be a global economic slowdown.

Today's U.S. payroll growth figures suggest the world's largest economy is still performing well, perhaps a bit too well. 256,000 new jobs were created during December, well above the forecast. These numbers could be revised but they indicate strength.

It was perhaps fortunate that there was little impact on wage growth, which has slowed over the last year. However, strong jobs growth raises concerns about how the labour market might react if the Trump administration is successful in taming immigration and thereby restricting labour supply.

As far as the balance of risks and opportunities is concerned, the most frequent challenge to the stock market, that of a recession, seems a distant prospect right now. Whether inflation continues to come down is increasingly in doubt.

We shall get a window into that next week, with inflation data for most major economies, including the UK and the U.S, due on Wednesday. Earnings season also begins next week. Earnings growth is expected to be strong over the next year

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