

**UK 2010 Emergency Budget: investment implications**

Chancellor George Osborne delivered the most significant UK fiscal tightening in almost 30 years, announcing swingeing cuts to departmental budgets, cuts/freezes in various welfare payments, a VAT tax increase and a two-year freeze in public sector pay amongst other measures. Although painful, the emergency budget suggests the UK government will bring this year's budget deficit of 10.1% of GDP under control, thereby avoiding a Greek-style sovereign debt crisis and instead allowing long-term interest rates to stay low. The Bank of England is likely to offset tight fiscal policy by keeping short-term interest rates lower for longer. Gilts and sterling are therefore the clearest winners from the budget. The implications for equities and the housing market are mixed.

by higher taxes. To put these cuts into perspective, total government spending in 2010/11 is projected to be £697 bn and total tax receipts £548 bn.

**UK government projected spending in 2010/11**

	£ Bn	% of total spending
Welfare & state pensions	194	27.8
Healthcare	122	17.5
Education	89	12.8
Defence	40	5.7
Public order & safety	35	5.0
Housing & environment	27	3.9
Social services	32	4.6
Transport	22	3.2
Industry, agriculture & employment	20	2.9
Other	73	10.5
Interest	44	6.3
Total Spending	697	100

Source: UK Treasury

**Fiscal consolidation**

The Chancellor has committed to achieve balance in the current underlying structural deficit by 2015/16, as well as an even more ambitious target that public sector net debt will be falling as a percentage of GDP by 2015/16.

This will be achieved principally by further cuts to departmental spending budgets than presented in the March 2010 Budget under the previous government. By 2014-15 government spending will be £32 bn a year lower and net taxes £8 bn a year higher than envisaged in the March budget.

This will result in a total fiscal consolidation of £128 bn per year by 2015/16, consisting of a reduction in government spending of £99 bn and a net increase in taxes of £29 bn. In percentage terms, by 2015/16 77% of total consolidation measures will be achieved by lower government spending and 23%

However, not all government departments will be affected equally. Taking into account an automatic increase in items of spending such as servicing debt interest, and the ring-fencing of spending on the health service and overseas aid, the coalition government estimates that cuts in real terms to other departments' budgets of up to 25% by 2015/16 could be needed.

The Autumn Spending Review, due to report on 20<sup>th</sup> October, will provide more detail on where the axe will fall in terms of specific departments, though the Chancellor hinted that he was sensitive to spending needs for defence and education.

This suggests other large spending departments such as transport, social services, police and housing and the environment could be particularly hard hit in terms of cuts to their spending budgets. The Chancellor said he would not cut capital

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expenditure more than had already been projected in the March 2010 Budget. But the March 2010 Budget had already incorporated very tight capital spending plans. Areas of spending with large capital budgets include defence, transport, education and health.

Other significant spending measures included in the budget included a freeze on public sector pay increases for two years for civil servants earning more than £21,000.

Significant tax measures included an increase in VAT from 17.5% to 20% effective from 4<sup>th</sup> January. Although this will create another spike in CPI and RPI inflation, the Bank of England is likely to 'look through' this, and not respond by raising interest rates. Capital gains tax for higher-rate taxpayers will be increased from 18% to 28% from midnight. The Chancellor is also introducing a bank levy, determined by the size of banks' balance sheets, which is expected to raise £2 bn a year for the Treasury.

### Investment implications

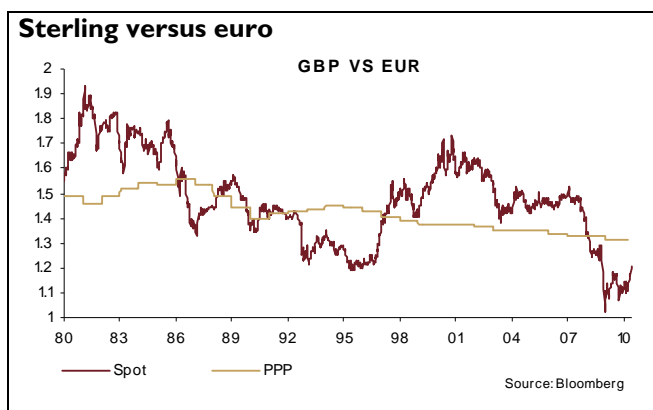
The measures substantially increase the chances that the UK will keep its triple-A credit rating. In particular, the fact that consolidation is being driven primarily by cuts in government spending increases the chances of success in terms of achieving the aim of consolidating the public finances. International historical evidence shows that fiscal consolidation is easier to achieve when it is driven primarily by lower spending rather than through tax increases. This should reassure international and domestic investors concerned about the UK's fiscal situation, helping keep long-term interest rates low and supporting sterling. Investors will also be reassured by the fact that the government is using more realistic growth and inflation forecasts provided by the newly created and independent Office for Budget Responsibility (OBR), when deciding how much fiscal consolidation is need to stabilise the public finances. Indeed, if the government is successful in consolidating the public finances, the UK could even come to be viewed as a safe haven for international investors.

### Bond markets

As we have previously highlighted, the offset to extremely tight fiscal policy is likely to be extremely loose monetary policy, with the Bank of England set to keep interest rates lower for longer. UK government bond markets should therefore get support from both lower long- and short-term interest rates.

### Sterling

The emergency budget is positive for sterling, particularly against the euro where the political risks surrounding fiscal consolidation are greater. Sterling is also still undervalued on a long-term purchasing power parity (PPP) basis against the euro.



The implications for sterling versus the dollar are less clear, given the lack of significant undervaluation, but probably still positive for sterling. The Budget also sets the stage for an interesting debate on the pace of fiscal consolidation at the G20 summit this weekend, with US President Barack Obama recently warning against tightening too quickly.

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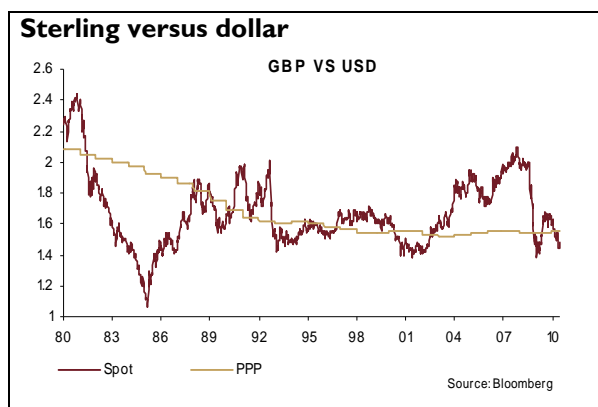
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## Equity markets

Equity markets will get some encouragement from a one percentage-point per year reduction in corporation tax over four years, gradually bringing the UK corporate tax rate from 28% to 24%. However, this will be offset by weaker growth at least in the short-term from lower government spending, the increase in capital gains tax and an increase in other taxes such as VAT, which could hit consumer spending. The biggest impact on equities could come at a sectoral level, between these sectors most and least exposed to spending cuts, given that they will not fall uniformly across all departments, as we have explained in previous Daily Themes.

## Housing

The UK housing market should benefit from interest rates staying lower for longer. However, this will be offset by a likely increase in public sector redundancies, which are inevitable given the scale of government spending cuts envisaged. The regions most dependent on government spending will be hit hardest. Wales, the North East and Scotland are the three regions with the highest proportion of the labour force in the public sector, while London has the lowest proportion. The London property market also benefits from being viewed as an attractive place for international investors, suggesting the London property market will outperform other regions.

## Conclusion

Although extremely painful, the 2010 Emergency Budget will go a long way in reassuring investors that the UK government can bring the sizeable budget deficit under control and stabilise the public finances. Long- and short-term interest rates should therefore stay low, supporting the bond market. However, the price to pay will be slower growth for some years because of lower government spending. Sterling should nevertheless benefit from the UK's greater deficit fighting credentials, especially versus the euro, against which it is undervalued on a PPP basis, and where political risks are higher.

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