Vanguard

Market Commentary

September 2022

How the mini-budget changes our economic outlook for the UK

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- The mini-budget will likely boost the UK economy in the near-term, but we still expect a mild recession in 2023.
- Our UK inflation outlook remains unchanged, while we now expect interest rates to reach around 5%.
- UK markets are likely to be turbulent until markets regain confidence in the economy.

Introduction

The reaction to last week's 'mini-budget' announcement was an indication that markets fear the government's substantial fiscal easing package could put the UK's public finances on an unsustainable path.

The pound briefly fell to a record low against the US dollar, while UK bond yields rose sharply and share prices fell, reflecting fears that the new policy measures, which represent the greatest easing of fiscal policy in the UK since 1972, will need to be funded by more borrowing.

It's still too early to draw any concrete conclusions about the longer-term impact of the mini-budget. Yet there are already some probable outcomes we think investors might reasonably expect over the next 12 months or so.

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A boost for growth but a (mild) recession still looms

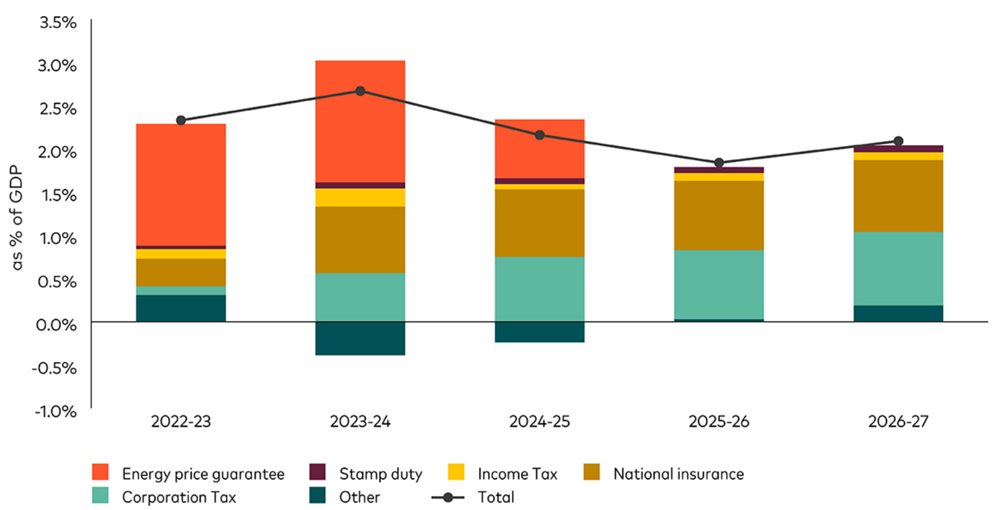
The fiscal easing measures announced by Chancellor Kwasi Kwarteng, which included further support for energy bills and stamp duty relief as well as household and business tax cuts will, in our view, likely boost near-term growth for the UK economy. But not by much – and not for long.

We still think there will be a recession in the UK in 2023, but instead of three quarters of negative economic growth, which we expect to start next month, we now expect a milder recession lasting only two quarters.

The chancellor has set the UK a new growth target of 2.5% but history tells us that raising an economy's long-term growth rate can be difficult. The target set by the chancellor would represent a significant jump from the country's average growth rate of roughly 1.9% a year since 1997.

If this growth target isn't realised, public finances are at risk of being placed on an unsustainable path.

Expected cost of fiscal measures as a % of GDP



Source: Vanguard calculations, The Growth Plan 2022 (publishing.service.gov.uk), as of 26 September 2022.

Inflation expectations unchanged

The energy price cap announced by Prime Minister Liz Truss earlier this month had already brought our 2022 peak headline inflation expectations down from 14% to 10%. Thereafter, we expected headline inflation readings to come down to less than 4% by the end of 2023.

The fiscal package is expected to increase consumer and business spending, which given the constraints on the supply side of the economy could lead to higher inflation readings. However, we've kept our inflation forecast unchanged.

That's because the announcement was accompanied by a meaningful tightening in financial conditions as investors priced in a higher and faster path of interest rate hikes by the Bank of England, which we expect will offset any additional inflation impulse from the mini-budget. Some of that has also already spilled over into the mortgage market.

Interest rates going higher for longer

The Bank of England had already increased its bank rate – the rate it charges other banks and lenders to borrow funds – from 1.75% to 2.25%, one day before Chancellor Kwarteng's announcement.

News of the government's significant fiscal easing measures prompted the BoE's governor, Andrew Bailey, to state that the central bank "will not hesitate to change interest rates by as much as needed to return inflation to the 2% target sustainably in the medium term".

Market volatility has also caused the Bank to announce it will buy longer-dated government bonds to ensure the proper functioning of market conditions and to maintain financial stability.

We now think the UK's bank rate will peak at around 5%, which is up from our pre-budget announcement expectation of 4.5%.

The bank's next policy meeting comes on 3 November and, at the time of writing, markets expect the bank to raise rates to 3.5% at the meeting.

Heightened uncertainty is more reason to stay diversified

There is still lots of uncertainty about how the (not-so) mini-budget plays out. UK markets are likely to remain turbulent in the near term until investors regain confidence in the UK economy, which is even more reason to maintain a well-diversified portfolio of global shares and bonds that aligns with their tolerance for risk.

Ultimately, downturns don't last forever and asset-class returns historically have rebounded towards long-term trajectories. That's why, now more than ever, we encourage our investors to look beyond the volatility, stay the course and stick to a balanced, long-term investment strategy.

Investment risk information

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