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The Rite of Spring

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Some form of Spring seems to be in the air, finally, although this time of year is notorious for delivering false starts. I spent a few hours in the garden at the weekend and it's encouraging to see green shoots and buds everywhere. Our garden faces north and so a lot of the planting closer to the house sees no sun until later in the year. I'm still waiting for the daffs to bloom, but it will be worth it. Not much sun has shone on the British economy recently either, and so the Chancellor, Rachel Reeves, faces a stiff test when she presents her Spring Statement this week. Will the economy be a late bloomer, or is it to be perpetual winter?

With all the “noise” around President Trump’s tariffs and other policies, the geopolitical situation in Ukraine and the Middle East, technological developments in China, and the extraordinary shift in Germany’s attitude to its fiscal deficit, it can be quite easy to overlook what’s going on at home. But, even if we are directing more of our investments overseas in search of a wider and deeper pool of opportunity, the fate of the UK economy is very important from the perspective of interest rates, bond yields and the level of the pound, not to mention the direct exposure that some of our equity and credit investments have to the UK economy.

The background to the Spring Statement is challenging, to say the least. Ms Reeves’s first Budget actually set a very low bar in terms of the ability to deliver positive surprises in future, but the last few months have not been kind to her. The economy has continued to be sluggish at best and inflation is proving to be harder to push back down to the Bank of England’s 2% target than one would have liked. Interest rates and bond yields remain higher than expected, increasing the projected levels of interest required to be paid on our debts. No doubt some of this sluggishness was self-inflicted by the increase in various taxes as well as by the imposition of higher employer national insurance payments which has led to a decrease in intentions to hire and invest.

My colleagues have produced a document (Spring forecast: the best laid plans | Rathbones) that goes into some excellent detail about the specific things to look out for. The key thing, for me, will be what the Office of Budget Responsibility has to say about the government’s finances. We noted last October that the “headroom” between the Chancellor’s spending plans and the means to deliver them was very slim, meaning that any unexpected increase in liabilities or reduction in income was going to require a Plan B. The budget was, in fact, squeezed from both ends thanks to higher bond yields and lower growth. Various estimates we have seen suggest that the government is now around £5bn “offside”, hence the news about cuts to welfare payments, for example. We’ve also seen a pledge to increase defence spending funded from a cut in the foreign aid budget. There really is no wiggle room. The situation is such that these are the sorts of policy changes that, had they been delivered by a Conservative government, would have had Labour MPs baying for its blood!

Mercifully, and because this not an official “Budget”, there are not expected to be any further changes to taxation levels, nor (after public outcry) any changes to, for example, Cash ISA allowances. Even so, Ms Reeves might prepare the ground for adjustments in the next Autumn Budget. I’m not going to make myself popular by saying that I have long believed that higher taxes on wealth are almost inevitable in the long term unless we can find some sort of productivity-led growth miracle (of which I remain sceptical, but I’d love to be pleasantly surprised). First it will be a case of reducing what goes into certain products (think ISAs and pensions) and then it will be taxing what comes out more. And at some point, I can’t rule out some form of wealth tax levied on overall assets (which is not uncommon in other countries including Norway, Spain and Switzerland and, selectively, in France and Italy). Neither can I see the avoidance of some sort of Land Value Tax being imposed one day. I really hope I am being too pessimistic on this front, but things like the cap on tax-free pension contributions for higher earners and the reduction of Capital Gains Tax allowances are already pointing in this direction. The lifting of the pension Lifetime Allowance was a vote-grabbing exception that proves my rule.

How has all of this played out in financial markets. Let’s start with short-term interest rates, which are mainly affected by the Bank of England. Having left rates unchanged at last week’s meeting, the Bank now skips April, with the next meeting on May 7th. Last September, when investors were eyeing lower inflation and there was a bit of a growth scare in the United States, the futures market thought that the base rate could be at 3.75% by May. Well, it's currently stuck at 4.5%, and there is around a 60% probability that it will be cut to 4.25% at the next meeting. Even by the end of 2025, the best we can hope for is around 4%, according to market pricing, which would still be a high rate if GDP growth this year struggles to get above 1% (which is where consensus estimates are pitched according to Bloomberg – and that's down from 1.5% in January).

However, as it made clear last week, the Bank is hemmed in by an inflation rate that refuses to fall fast enough. We'll see exactly where it is on Wednesday, but the forecast headline rate is 3%, with the core rate at 3.6%, a long way from the 2% target (even we allow them a bit of slack to let it run hotter). Services inflation (forecast to fall from 5% to 4.9%) is the main problem, with a big element of that being wage inflation, currently running at 5.8%. That might sound good in terms of real wage growth, but it is not being funded by productivity growth and therefore just imposes a higher level of costs on the economy.

Neither is there solace at the longer end of the yield curve, with the 10-year Gilt yield currently poking above 4.7% again, which is not far from the 4.88% level reached in January when there was a mini-crisis in bond markets. Disturbingly, that's higher than the level (4.50%) reached during the Truss/Kwarteng-induced meltdown in 2022. Even so, we should point out that the second order effects, such as felt in the LDI pension industry in 2022, appear to be contained this time. There certainly seems to be relative calm in the Gilts market. While we will have to keep an eye on this situation, it gives us comfort in our recommendation structurally to shorten duration exposure in our fixed income portfolios.

What about the pound? It has fared better against the dollar recently, up from a low of $1.22 earlier this year to $1.294. That's largely a function of a weaker dollar as currency traders have voted against President Trump's aggressive and disruptive policy stances. Sterling has lost a bit of ground against a resurgent euro, but not much in the grand scheme of things. A stronger pound against the dollar is helpful in keeping even higher inflation at bay, although aggregate commodity prices (which tend to be priced in dollars) have been creeping up, which means that the benefits are limited.

A stronger pound tends to lead to underperformance of the FTSE 100 Index owing to its higher degree of non-sterling revenues, but it has still performed well, returning more than 5%. The main contributors this year (in terms of index points) have been HSBC (strong profits and exposure to improved China sentiment), Rolls Royce (still positively surprising on earnings), Shell (oil price recovery), Astra Zeneca (defensive safe haven) and BAE Systems (increased defence spending). That's quite a differentiated group in terms of economic or sector exposures as compared to some other markets. The UK stock market does have some virtues!

I mentioned last week that we tend not to hedge currency exposure unless there is a very specific reason to do so. On being tested further on this front, I calculated the average sterling/dollar exchange rate in the post-Brexit world. Remarkably it came out at $1.288, which is around half a percent from where it is now. Yes, it has traded in a range as wide as $1.43 down to $1.03,but we can't identify a specific reason why it would test those extremes imminently. As long as the Chancellor keeps to a sensible path on Wednesday

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