UK Watch

Autumn statement review: inflation risks

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Chancellor spends improved revenues

Today's Autumn Statement saw Chancellor Jeremy Hunt spend increased revenues on tax cuts. The tax cuts boost demand only a little, 0.1% at the peak with a similar impact on inflation, so they do not move the central case economic outlook much. But we think today's statement boosts upside inflation risks. First, we think it's likely the government will spend more than currently planned, adding to the demand effects from tax cuts. Second, we see policy choices today as signalling further tax cuts are likely next March. Third, the forecasts today assume the government hikes fuel duty in April which looks highly unlikely to us. That is worth another £6bn a year. Fourth, we see a risk that fiscal measures have an outsized effect on the inflation outlook currently, given potentially less well anchored inflation expectations now.

Borrowing and debt little changed

Updated forecasts from the Office for Budget Responsibility (OBR) show government borrowing little changed in the medium term, but lower in the near-term (Exhibit 1). Stronger than expected tax receipts, reflecting unexpectedly strong nominal GDP (domestic inflation), cut borrowing throughout the forecast. 2023/24 borrowing was cut to £124bn from £132bn, close to our call of £121bn. 2024/25 was cut to £85bn, well below our forecast of £105bn. The impact of higher receipts are fully offset by higher welfare and debt interest spending along with tax cuts further out in the forecast (Exhibit 2)

Real government spending cut

The Chancellor was able to use higher receipts driven by higher inflation to cut taxes because he kept nominal government spending plans, outside welfare and debt interest, largely unchanged. With higher inflation this translates into a £19bn real terms cut in planned departmental spending for 2027/28. As the OBR write "As previous spending reviews have approached, governments have topped up annual day-to-day spending envelopes significantly: by £39 billion (14 per cent) on average in the year up to the November 2015 Spending Review, and by £32 billion (8 per cent) in the October 2021 Spending Review. The outlook for departmental spending is therefore a significant and growing risk to our forecast.". We think it is highly likely that the government will spend more than planned.

Limited headroom against fiscal rules

The headroom against the fiscal rules looks thin, especially when taking account of the likely cancellation of the fuel duty rise next year. The five-year horizon at which the fiscal rules are assessed – debt-to-GDP falling and borrowing less than 3% GDP – rolled out one year today to 2028/29. By planning tight government spending for an extra year the Chancellor raised headroom against the rules compared to the March forecasts. The rules are met by a margin of £13bn (0.4% GDP) in the OBR's current forecasts, up from £6.5bn in the previous forecasts. **(Continued on next page.)**

Timestamp: 22 November 2023 11:10AM EST

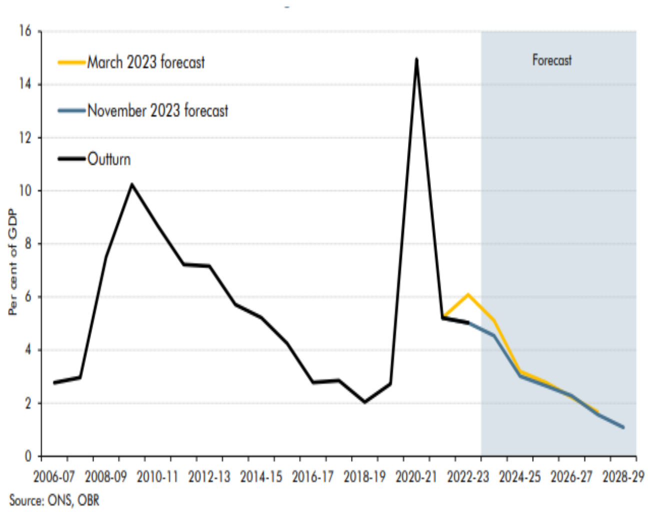
But that headroom assumes £6bn of revenue from raising fuel duty in line with inflation, starting next April. We think that is highly unlikely, given the government has frozen fuel duty repeatedly in the past. With upside risks to spending too, we think borrowing is more likely to overshoot. The fiscal rules provide little constraint, however, because the five-year horizon rolls forward a year every year. The government only has to forecast to meet the rule.

Cutting taxes with inflation more than double the target

Inflation has come down sharply, below the government's target of 5% by year end. Of course, that intermediate target is two-and-a-half times the Bank of England's inflation target of 2%. We think this is a delicate time for returning inflation to target, and we see increased upside risks from today. The tax measures are not large. They do not move our central case. But we see risks of further tax cuts in March and the potential for this to further modestly destabilise inflation expectations. We would see greater upside inflation risks from the minimum wage increase this year compared to earlier years.

We stick to our call for the BoE to hold Bank Rate at 5.25% through 2024 with the first cut in February 2025. The risks skew to an earlier cut, but we doubt the potential for rate cuts in 1H 2024. By the May Monetary Policy Report, for instance, the BoE will have inflation data only for March and may have just seen another modest fiscal stimulus in the Budget. We suspect prudence from the Bank of England would make them wait beyond May to consider a cut.

Exhibit 1: Public sector borrowing forecasts little changed since March
OBRf Public Sector borrowing



Source: OBR

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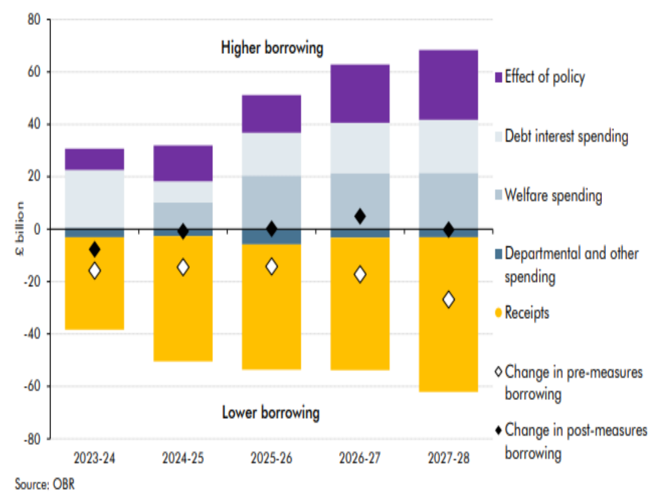
Exhibit 2: Tax cuts and debt interest spending offset improved receipts
Change in OBRf public sector borrowing



Source: OBR BofA GLOBAL RESEARCH

Emphasis on T-bill reduction in line with our expectation

The Debt Management Office (DMO) kept Gilt sales broadly unchanged (-0.5bn relative to its April update), opting to reflect £10.5bn reduction in Net Financing Requirement (NFR) via £10bn reduction in net T-bill sales (Exhibit 3). Emphasis on T-bill reduction was in line with our thinking (Autumn Statement preview: limited room, 14 November). Price action suggested it came as a surprise to the market likely braced for larger reduction in Gilt sales (£13bn cut according to Bloomberg survey conducted last week).

Large upward revisions to DMO's Illustrative Gross Financing Requirement (IGFR) projections for 2024-2028 - +£6bn in 2024/25; +30.5bn in 2025/26; +£28.1bn in 2026/27 (Exhibit 4) – reinforced our thinking that unchanged Gilt sales in November will help achieve smoother Gilt issuance into fiscal year 2024/25. They also support our bearish 2024 outlook – we expect more persistent risk premia being priced even as the

BoE eventually starts cutting (2024: Cloudy with a chance of landing, 19 November).

National Savings and Investment (NS&I) projection unchanged at £7.5bn stood out to us also. Our projection for a £10bn increase was based on very strong inflows (£12.1bn) fiscal year-to-date (UK public sector finances in October: set for undershoot, 21 November) and press reports that the Chancellor would lean more on NS&I funding. Unchanged target of £7.5bn implies NS&I outflows from here (Exhibit 5).

Exhibit 3: UK DMO Remit for fiscal years 2023/24 incl. BofA projections prior, £bn
Broadly no change in Gilt sales, £10bn cut in net T-bill sales

UK DMO financing Remit arithmetic (£bn)	FY 2023/24 (DMO - Apr'23)		FY 2023/24 (BofA - Nov'23)		FY 2024/25 (DMO - Nov'23)	
CGNCR	159.5		157.2		150.5	
Redemptions	117.0		117.0		117.0	
Adj. from prev. FY	-24.6		-24.6		-24.6	
Gross Financing Req. (GFR)	251.9		249.6		242.9	
Less:						
NS&I	7.5		18.0		7.5	
Other financing	1.5		1.5		3.0	
Net Financing Req. (NFR)	242.9		230.1		232.4	
To be financed through:						
Gilt sales, through:	237.8		230.0		237.3	
Short conventional	*84.6*	*36%*	*85.0*	*37%*	*86.6*	*36%*
Medium conventional	*65.3*	*27%*	*65.0*	*28%*	*68.3*	*29%*
Long conventional	*49.7*	*21%*	*50.0*	*22%*	*51.3*	*22%*
Index-linked	*26.2*	*11%*	*26.0*	*11%*	*28.6*	*12%*
Unallocated	*12.0*	*5%*	*4.0*	*2%*	*2.5*	*1%*
Net T-bill sales	5.0		0.0		-5.0	
Total financing	242.8		230.0		232.3	
DMO net cash position	2.3		2.3		2.3	

Source: Debt Management Office, BofA Global Research

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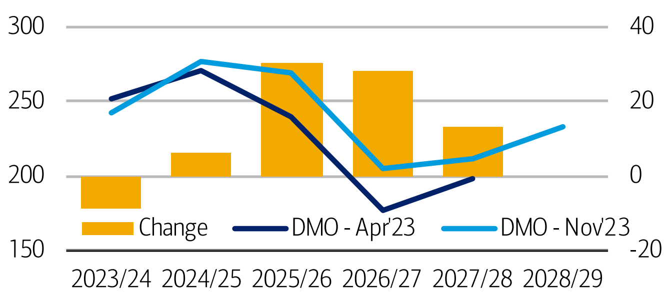
Exhibit 4: DMO's illustrative gross financing requirement, £bn
+£78bn in 2024/25 to 2027/28



Source: Debt Management Office, BofA Global Research

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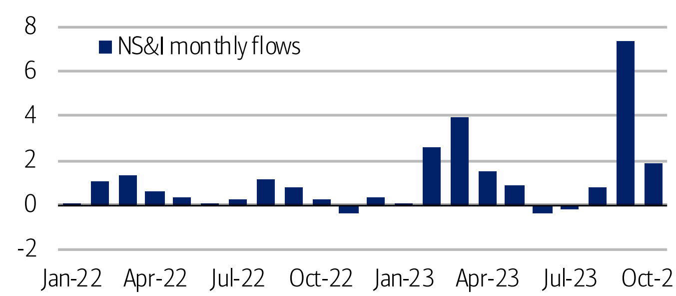
Exhibit 5: NS&I monthly flows, £bn
A slowdown after withdrawal of September's record 6.2% 1y NS&I deal offer



Source: Office for National Statistics, BofA Global Research

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GBP: Saved by the bell

Up until the last minutes of the AS, GBP price action suggested a degree of disappointment that the Statement did not stack up with the media reports for a more comprehensive package of personal income tax cuts. Though the 2pt cut in NI was a surprise, the OBR forecast update made for gloomy reading with growth expected to be lower next year compared to the March forecasts. Though the Chancellors message was a clear one, focussing on supply side measures, the subsequent read-through from the likes of the IFS and OBR have focused on the increased tax burden and declining living standards. The only saving grace for markets is that this was not the blockbuster event it was last year which led to significant dislocation in UK assets. It is more than likely that the 2024 Spring Budget will provide the platform for more wide-ranging tax cuts on stamp duty, inheritance, and personal taxation. But we are left with the sense that today's announcement will do little to revive the fortunes of the UK economy. As a result, GBP will likely remain shackled to the low growth/high inflation narrative that has been central to its underperformance in recent months. UK yields are higher on the back of the gilt remit numbers but we doubt that this will provide any support for the pound. The BoE response will be followed closely but in our view, the AS does not provide enough fuel for markets to price out rate cuts next year. We find it hard to find a UK specific scenario that could sustainably improve GBP sentiment headed into the end of the year. The key to GBP/USD may well be how USD trades against the backdrop of Fed rate hike expectations but we would argue that there are better ways than cable to express a bearish USD view.

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