UK Watch

Budget preview: a bit more headroom

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Macro
United Kingdom

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Some more headroom in the new forecasts

New forecasts in next week's Budget will in our view show some more headroom relative to the Autumn statement before new measures are factored in. We would expect somewhere around £15-20bn headroom (probably closer to the upper bound), potentially enough to cancel the fuel duty rise and implement additional small tax cuts. We work on the assumption that 1p off the basic rate of Income Tax is one of those cuts. Borrowing is likely to be marginally lower for '24-25 before potential new measures are factored in.

Some tailwinds, but not large ones

We would expect the nominal GDP profile to be moved marginally lower (Exhibit 1). We think there will be some reduction in the OBR's GDP growth forecasts near term, too, since growth has surprised to the downside. We also expect inflation forecasts to be revised down (mostly through less imported inflation). On the other hand, debt interest cost should move lower, but by less than we would have anticipated a few weeks back given the repricing of the Bank of England cutting cycle (Exhibit 2). Finally, we would expect a smaller indexation cost only in the current fiscal year to add to the headroom.

Broadly unchanged borrowing pre-measures

Given the discussion above, and with the current fiscal year going broadly to plan, changes in borrowing will be mostly down to Budget measures. We would expect the government to stretch the headroom with new measures, but remain agnostic on their size and composition.

A non-event?

Stretching the headroom now with the hope – perhaps not politically feasible – that real expenditure cuts in the future take the debt profile lower comes with risks. But this has been the norm for quite some time and largely anticipated for this budget. As long as any announcement stays within the margins of what we discuss above, we would not expect a large reaction from markets.

But with some risks

But given recent press reports we worry about potential announcements that deliver more ambitious tax cuts now on the back of backloaded and very politically challenging real expenditure cuts in the future. The government has already pencilled in a 1% annual real terms spending increase for all departments. But in light of existing commitments for some (NHS, defence, foreign aid or childcare), that means more than a 2% drop in real spending for all other departments from April 2025. Going further in that direction ahead of an election could question credibility.

Refer to important disclosures on page 4 to 6.
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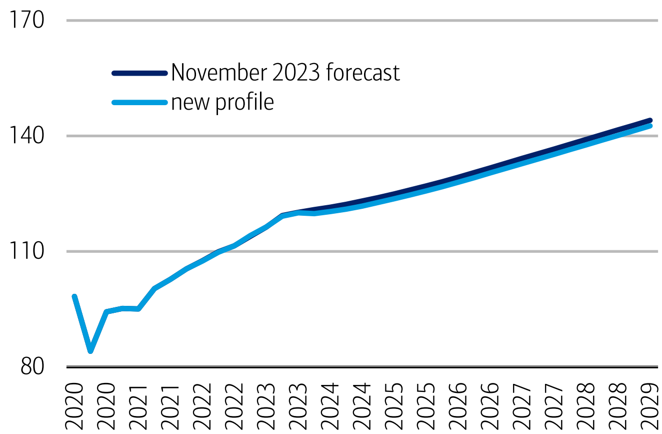
Timestamp: 01 March 2024 01:30AM EST

Likely to feed a cautious BoE

Given our expectation of additional measures we think the Budget will be mildly inflationary, adding another reason for the Bank of England (BoE) to be patient and cautious when starting a cutting cycle. We think the budget next week should reinforce our view that a slow cutting cycle is unlikely to start before August this year.

Exhibit 1: Nominal GDP profile
Nominal GDP profile likely to be slightly lower



Source: OBR, BofA Global Research

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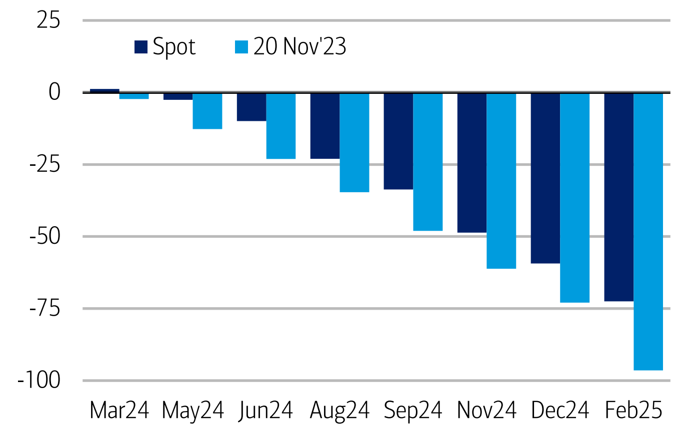
Exhibit 2: Market pricing of BoE cuts
Clear repricing since November



Source: Bloomberg, BofA Global Research

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Rates: Nothing to nudge the Budget

Our working assumption is that the Debt Management Office (DMO) will aim to meet any upside in the financing need via net T-bill issuance and National Savings and Investment (NS&I), minimising the need for material Gilt Remit changes. This would not be unprecedented; the net contribution of T-bills has been quite variable in recent years, with the DMO pencilling as much as £40bn in September 2022 (Exhibit 3).

We expect the Gilt issuance maturity split to mean fewer long and index-linked, more short and (quite a lot more) medium Gilts. Assuming the remaining unallocated portion of current Remit is used for the last linker syndication, this year's split will be 36% shorts, 29% mediums, 22% longs and 12% linkers.

For 2024/25, we pencil in 5% for unallocated, the same share as at the start of the current fiscal year. In line with late feedback from Gilt Edged Market Makers (GEMMs) and investors, we expect the shares of longs and linkers to be reduced to 17% and 10%, from 21.1% and 10.9% in March 2023, respectively. This allows shorts and mediums' weightings to be lifted to 37% and 31%, respectively (Exhibit 4 and Exhibit 5). A skew shorter *within* the long and linker buckets is also likely, meaning that the effective skew shorter will be greater than the simple bucket weights show.

Exhibit 3: Total net contribution of T-bills for debt financing, £bn
Big variation in net contribution of T-bills for debt financing in recent years

	2020/21	2021/22	2022/23	2023/24
March Remit	0	1.8	23.2	5
April revision	6	1.8	30.2	5
Sep'22 update			40.2	
Autumn Statement	-2	-23.2	33.2	-5
Outturn	-2	-23.2	33.2	

Source: BofA Global Research, Debt Management Office

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Exhibit 4: 2023/24 and 2024/25 Gilt Remit splits per "bucket", %
We expect 5% unalloc, 37% shorts, 31% mediums, 17% longs and 10% ILBs

	23/24	23/24	23/24	23/24	24/25 (f)
	Mar'23	Apr'23	Nov'23	Outturn (f)	Mar'24
Short	36.0%	35.6%	36.5%	36.5%	37.0%
Medium	27.1%	27.5%	28.8%	28.8%	31.0%
Long	21.1%	20.9%	21.6%	22.3%	17.0%
ILB	10.9%	11.0%	12.1%	12.4%	10.0%
Unalloc	5.0%	5.0%	1.1%	0.0%	5.0%

Source: BofA Global Research, Bloomberg

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Exhibit 5: UK DMO Remit for fiscal years 2023/24 and 2024/25 including BofA projections, £bn
We expect the DMO to aim to keep Gilt sales broadly unchanged

	FY 2023/24 (DMO - Apr'23)		FY 2023/24 DMO - Nov'23		FY 2024/25 (BofA - Feb'24)	
CGNCR	159.5		150.5		145.0	
Redemptions	117.0		117.0		139.9	
Adj. from prev. FY	-24.6		-24.6		0.0	
Gross Financing Req. (GFR)	251.9		242.9		284.9	
Less:						
NS&I	7.5		7.5		15.0	
Other financing	1.5		3.0		0.0	
Net Financing Req. (NFR)	242.9		232.4		269.9	
To be financed through:						
Gilt sales, through:	237.8		237.3		240.0	
Short	*84.6*	*36%*	*86.6*	*36%*	*88.8*	*37%*
Medium	*65.3*	*27%*	*68.3*	*29%*	*74.4*	*31%*
Long	*49.7*	*21%*	*51.3*	*22%*	*40.8*	*17%*
Index-linked	*26.2*	*11%*	*28.6*	*12%*	*24.0*	*10%*
Unallocated	*12.0*	*5%*	*2.5*	*1%*	*12.0*	*5%*
Net T-bill sales	5.0		-5.0		29.9	
Total financing	242.8		232.3		269.9	
DMO net cash position	2.3		2.3		2.3	

Source: DMO, BofA Global Research

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GBP: Fiscal Tailwinds

We think that the Spring Budget could be the trigger for further cyclical outperformance in GBP. At the start of the year, markets were concerned that the March Budget could precipitate the kind of market response similar to September 2022, as the UK Government stretched public finances to cut taxes ahead of the UK general election. However, as discussed about, the fiscal headspace has assuaged these concerns and with the rates market recalibrating the timing of the first BoE rate cut, fiscal stimulus could add further upward pressure to UK rates. As in September 2022, GBP is likely to take its cue from the reaction in rates market but on the assumption that UK yields rise for the right reasons rather than the wrong ones, this should be supportive for GBP in a market where carry remains a major driver for FX and against the backdrop of a weak vol environment.

Options Market Sanguine Ahead of the Event

Markets remain relaxed that there will not be a “fiscal mistake”. At the time of writing, both GBP/USD and EUR/USD 1wk implied volatility remains well anchored towards the lows for the year. Unsurprisingly, some premium has been placed into the curve given some residual concerns about the outcome, but this is relatively small. Whilst this would indicate that the event does not hold the market focus that it did at the start of the year, we continue to believe that should the Government deliver the kind of package discussed above, this could add further weight to the evidence that UK growth pessimism has now passed the trough. Of course, the asymmetry is obvious: should the government surprise with a package that tests the markets resolve. However, a focus on the consumer, against the backdrop of rising real incomes and full employment will be GBP supportive and raises further questions over the timing of the first UK rate cut.

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