Macro Overview

UK – Damaging Domestic and International Dynamics

Fixed Income Macro View

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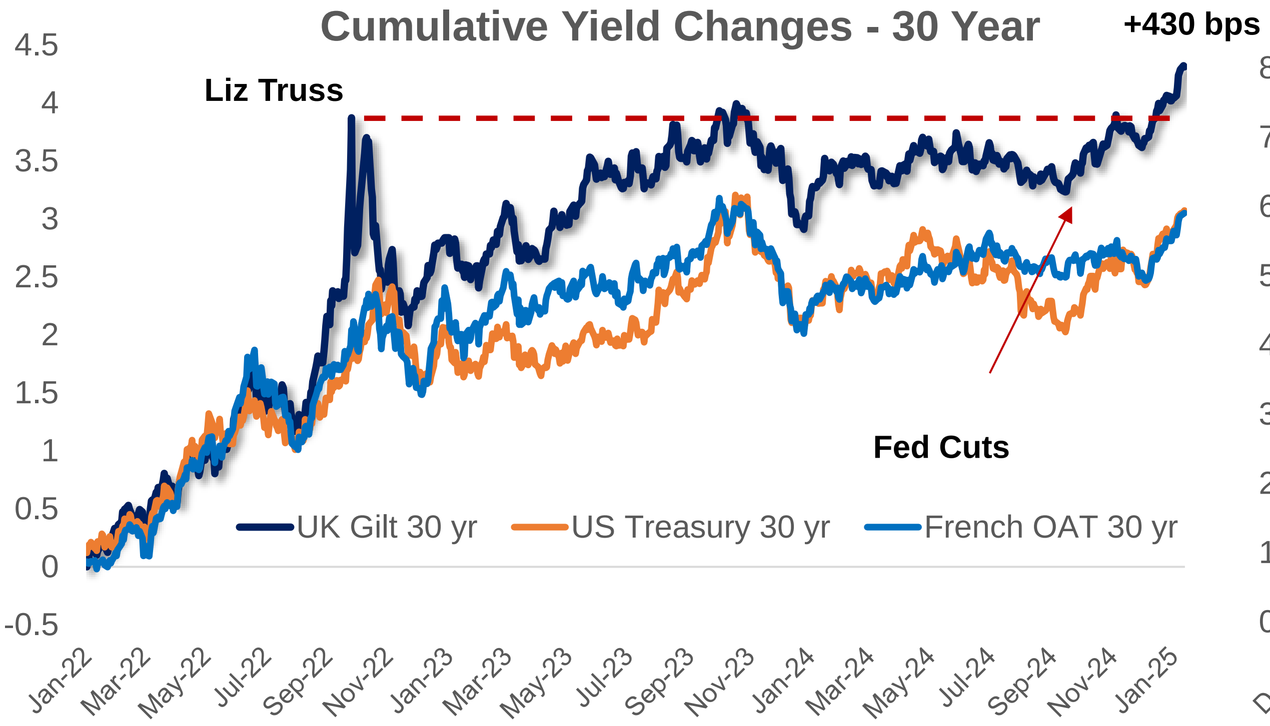
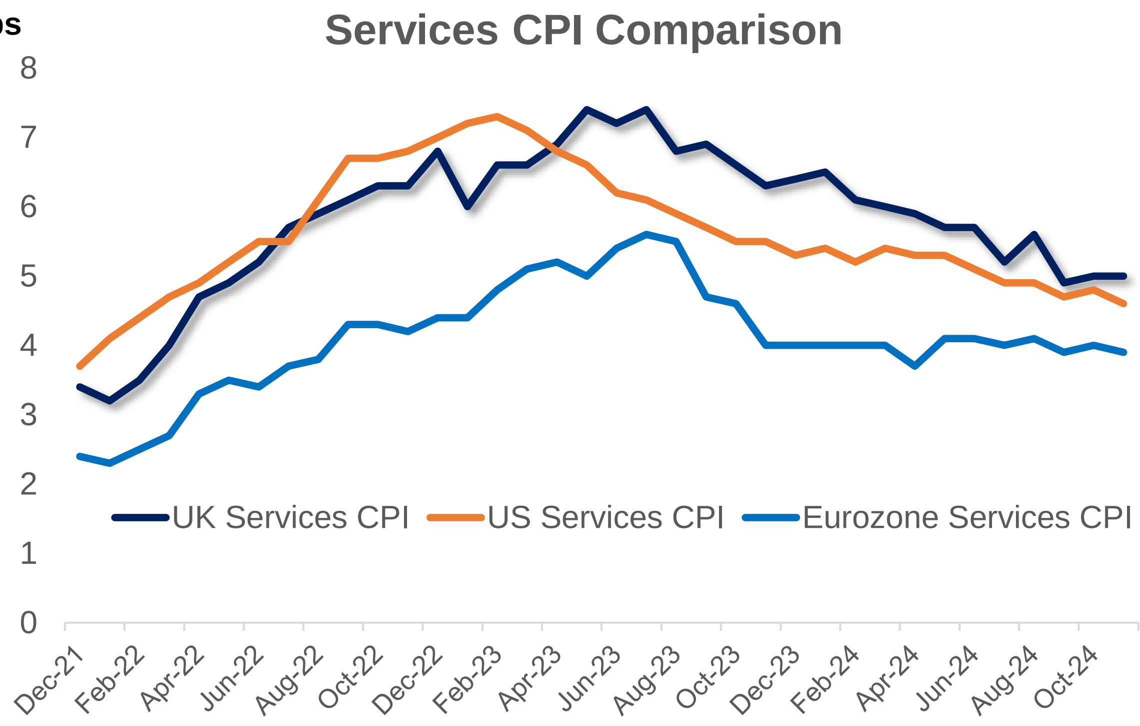
Summary

- **Lack of Investment and Policy Failures** have beset the UK economy since the Global Financial Crisis. The new government seems no more adept at dealing with these challenges than the previous one - the markets don't seem to be buying their solution any more than they were the last leadership.

- **Global Factors** are also responsible for the current predicament. The UK is not alone in facing a raft of significant challenges.



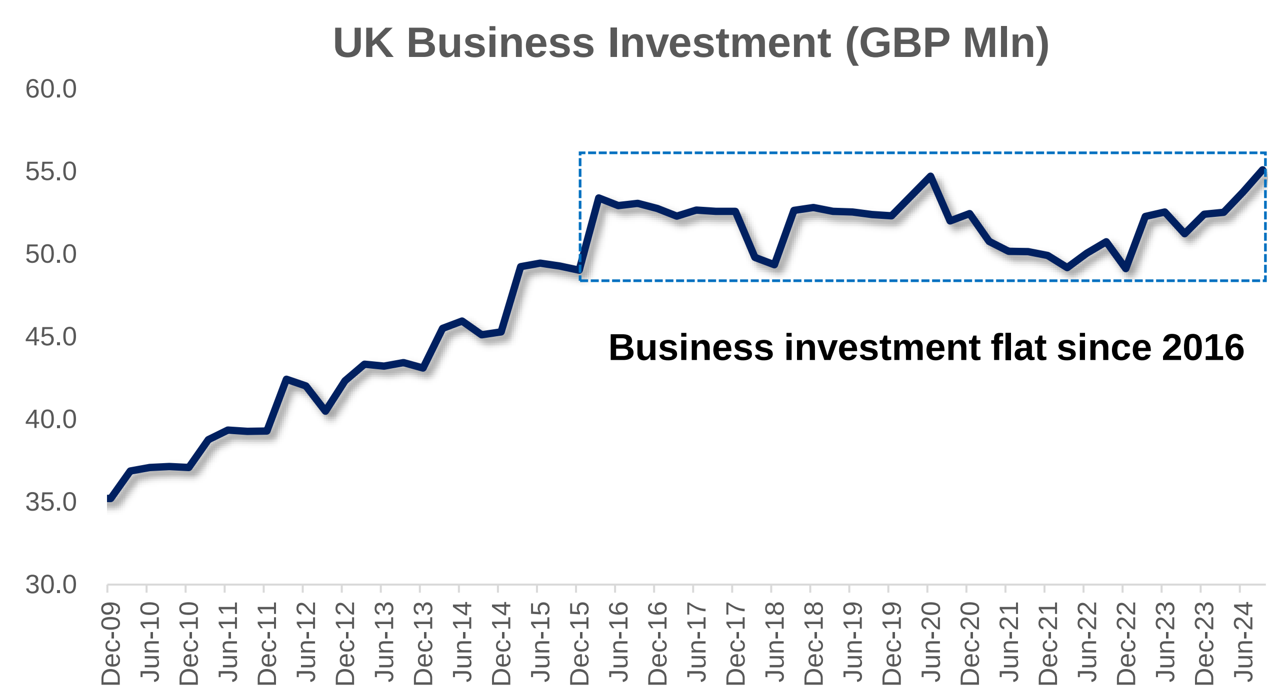
Source: Bloomberg as at 14/01/25



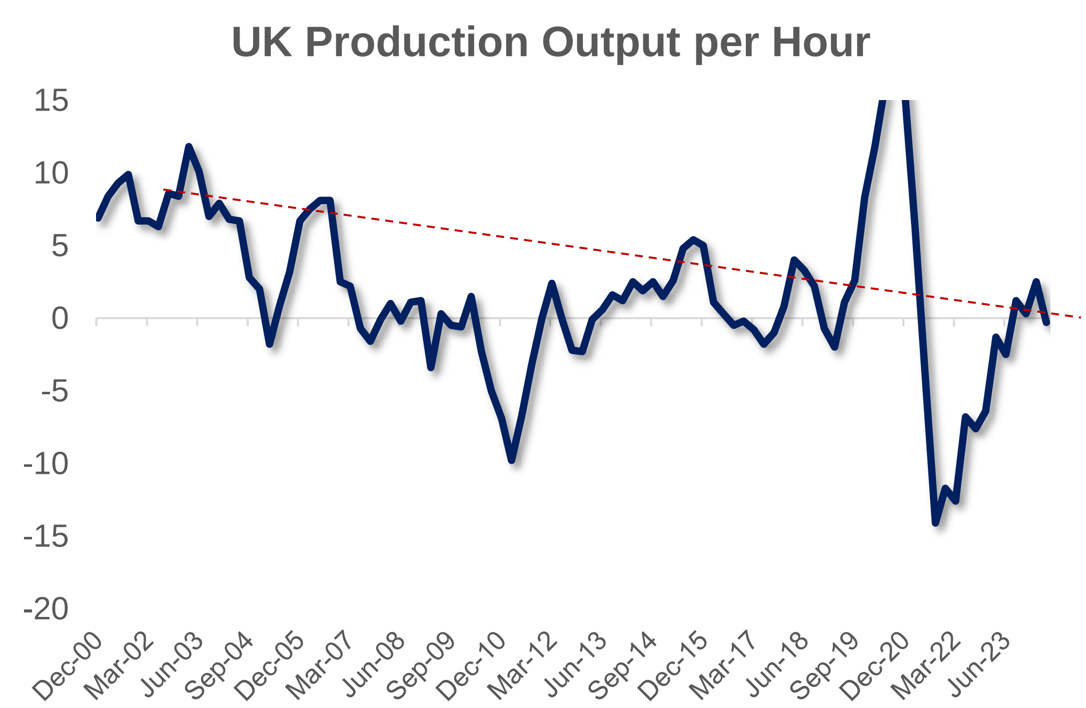
Source: Bloomberg as at 31/12/24

Structural Problem – Lack of Investment

Over the last week many market participants are once again asking tough questions about the financial health of the UK economy. While the challenges are in part unique to the UK, there are elements of the malaise that are evident globally, be it in Europe, Asia or even the US. Taking the UK situation first, while we endlessly hear the same points being made by politicians about the need for growth and productivity in the economy, they appear incapable of figuring out a way of delivering it. One clear reason for this is the lack of investment in the economy, both private and public. This has been borne out in declining productivity and has undoubtedly played into the strong inflationary pressures that have impacted the economy since late 2021. Labour shortages, most acutely felt during 2022, have also played a role in creating elevated wage pressures relative to other developed market peers.



Source: Bloomberg as at 31/12/24

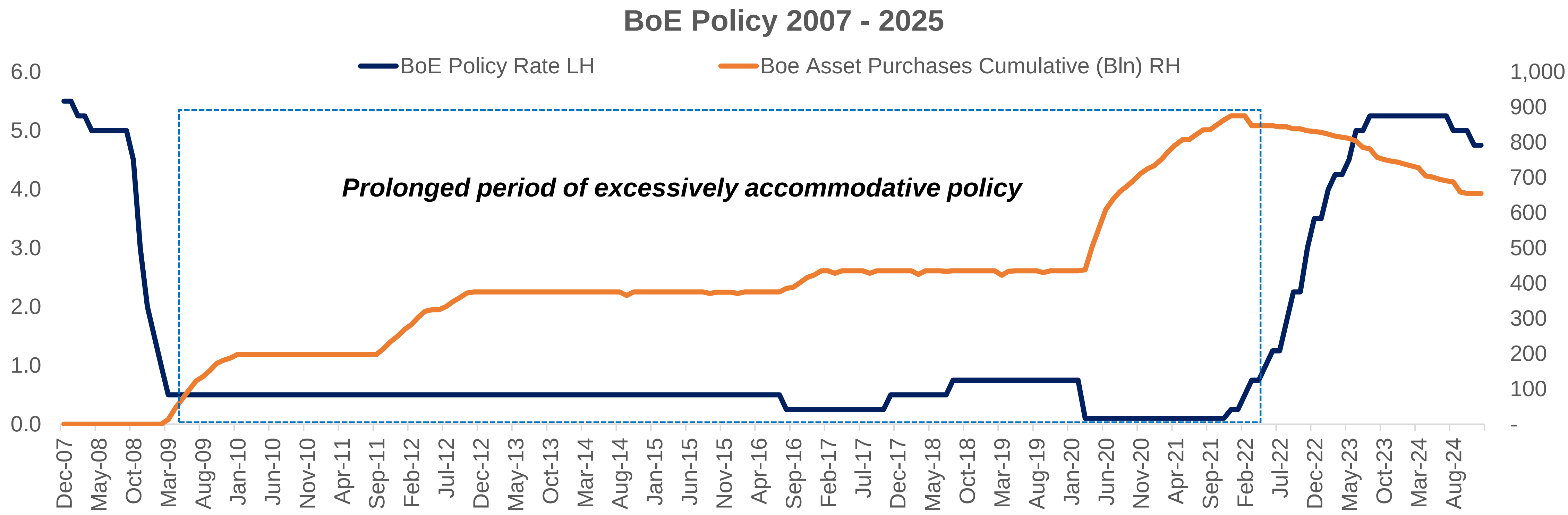


Source: Bloomberg as at 31/12/24

Rubrics Fixed Income Macro View

Structural Problem – Previous Policy Errors (ZIRP and QE)

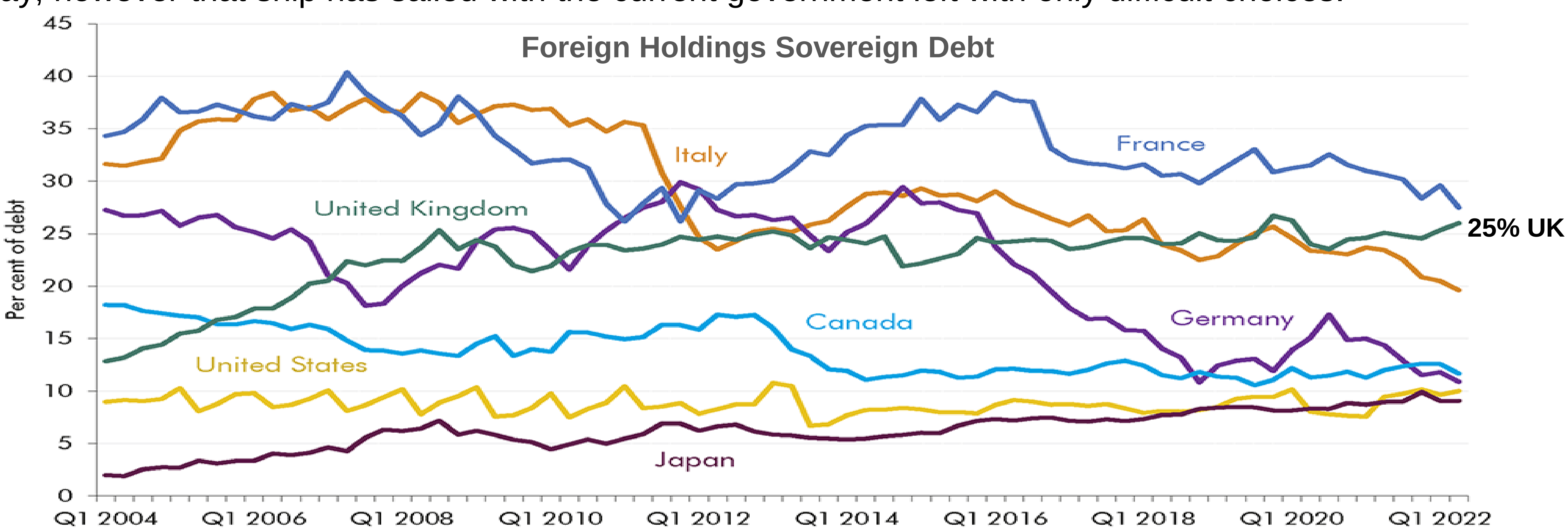
The second (less talked about) reason is the actions of the BoE since 2008. The prolonged period of zero interest rates and QE gave successive governments a 'get out of jail free card' allowing them to accumulate cheap debt without addressing the underlying structural problems of the economy. Under this environment nobody was incentivised to make good policy choices with politicians focused instead on populist rhetoric. Nevertheless, for much of this period all was well with the world, asset prices were rising (including house prices) and the cost of the ever-increasing debt load was manageable. That was until the pandemic struck. The sheer scale of the global response to COVID and the inflation that resulted has now laid bare a decade plus of poor policy choices.



Source: Bloomberg as at 14/01/25

Structural Problem – External Funding Reliance

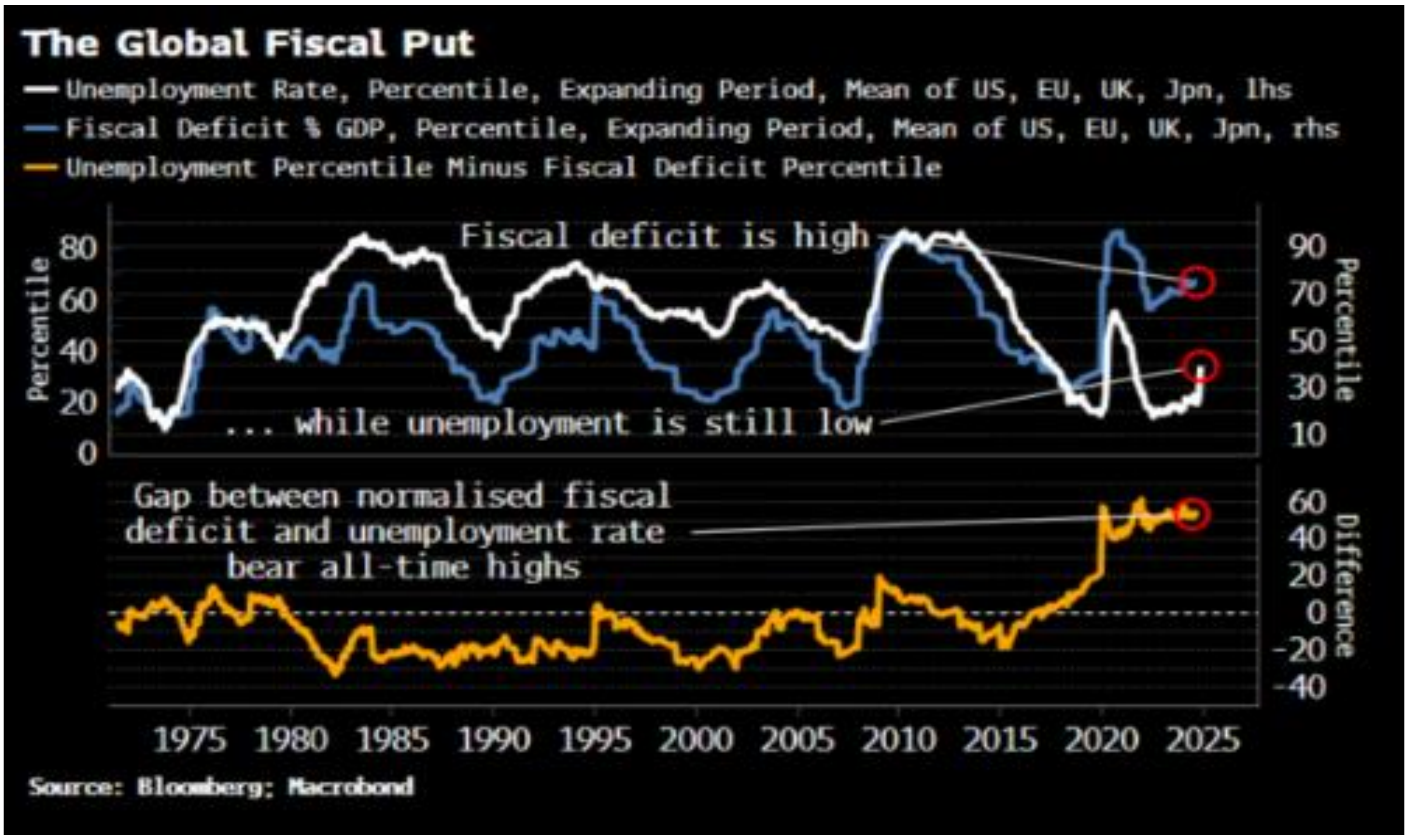
Recent market concerns were centred around the recent budget which gave no hint of forthcoming growth or of a government that has any understanding of how to achieve it. While it was unfunded tax cuts that did for Liz Truss in 2022, the unexpected increase in taxes for business employers really drew the ire of the markets this time around. The lesson here is there are no longer any easy solutions, particularly for an economy with the UK's reliance on foreign funding of its debt. Any policy mis-steps are magnified. Prevention is better than cure they say, however that ship has sailed with the current government left with only difficult choices.



Source: IMF

Global Factors

The UK is not in a dissimilar position to most other developed economies. In France we are seeming one government fall after another due to their inability to get a budget passed within (current) EU guidelines. French bond spreads widened past Greece's not so long again, a startling vote of no-confidence, while the Euro has even been underperforming the GBP. The US, home of the global reserve currency is probably the epicentre of today's bond market concerns. US treasury yields have risen considerably since the Fed's rate cuts in Sep '24, the first time this has happened since 1981. The market, in the short-term at least, has seemingly rejected the Fed's attempt at engineering a soft landing via pre-emptive rate cuts. This should not be surprising given the US is in the midst of the largest pro-cyclical fiscal spend on record - a policy that is also evident in other economies across the developed world and a major factor in keeping upward pressure on bond yields globally.

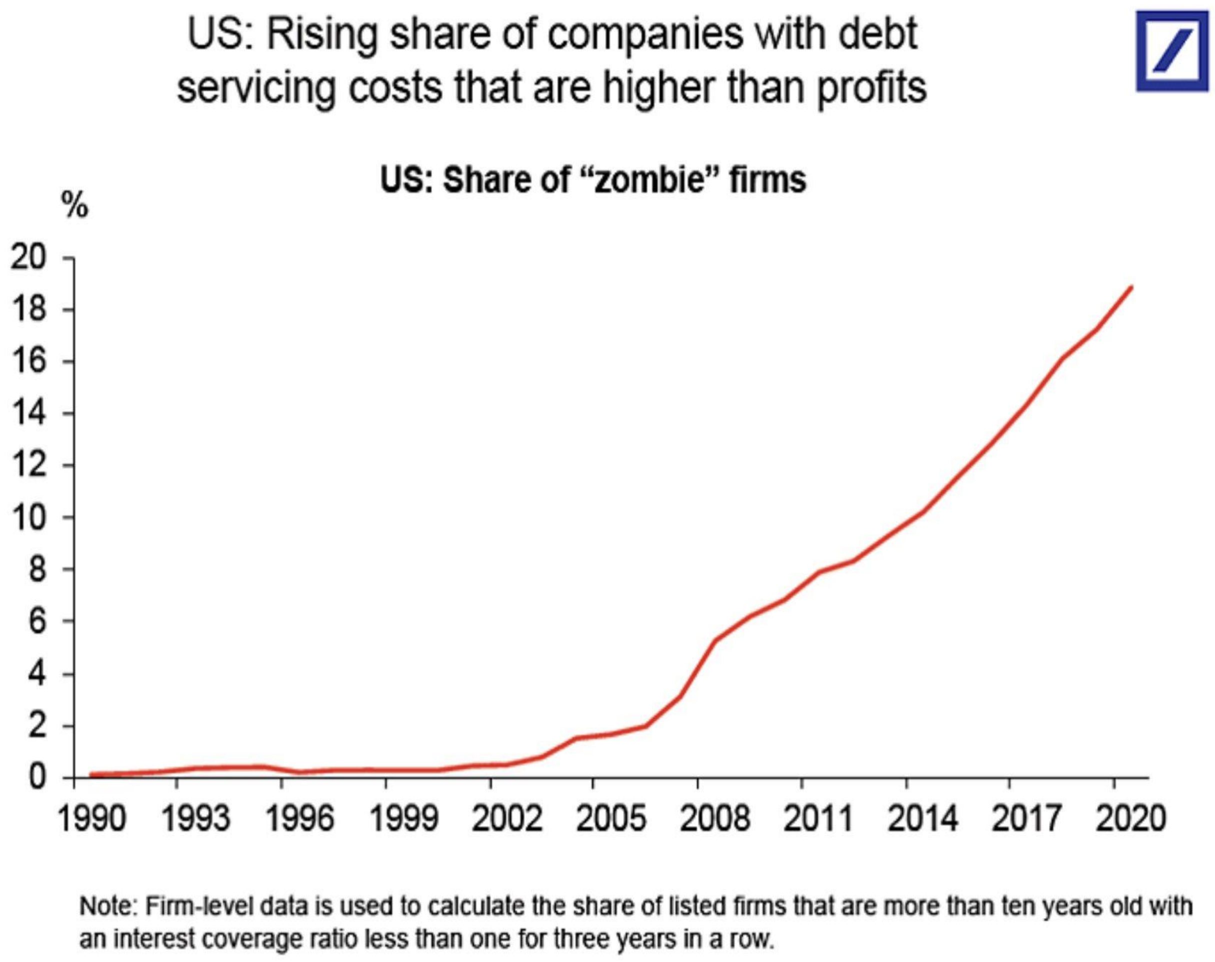


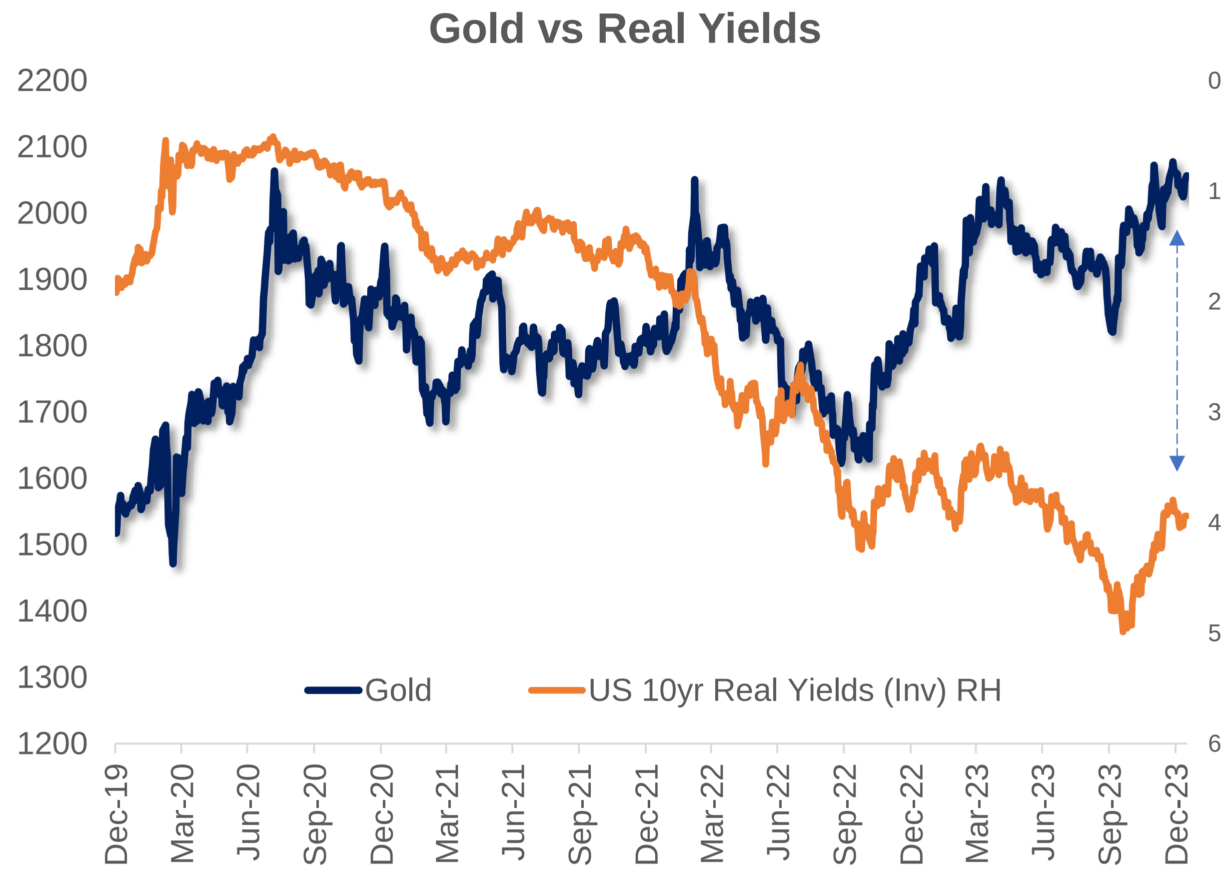
Forthcoming Respite?

Despite this higher for longer narrative, there should be a limit to how high yields can go. For one, the rising USD is putting significant strain on global trade, and if unchecked can act as a serious drain on global liquidity. This type of environment has tended not to be so good for risk assets and can give global bond markets some much needed respite. Given how elevated many financial asset valuations are at present, the risks of a major correction continue to grow, either through failure to meet lofty earning expectations or simply because a growing cohort of an aging population decide they want to sleep at night and earn 5% in bonds vs an overvalued equity market.

Tough Policy Choices

The UK is certainly not alone in seeing a discernible rise in populism. A decade plus of policy short-termism has resulted in economic outcomes that are simply not working for an ever-increasing cohort of the population. Rising inequality, falling productivity, increasing monopolisation and widespread ‘zombification’ are perhaps most prevalent in the US but are evident in most of the developed world. Bloated fiscal deficits and record high asset prices leave most economies severely restricted in what levers they can pull particularly when (not if) the next recession hits. Markets are betting on a continuation of the current policy mix (witness the price of gold) with little or no economic or market turbulence factored in. However, in the event that this goldilocks scenario doesn’t in fact come to fruition, policy makers may be forced into the unfamiliar position of focusing on real investment in productive assets (not crypto currencies).





Source: Bloomberg as at 14/01/25

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