UK: Autumn Statement Preview

CONTACTS

Alan Clarke
44.207.826.5986
Fixed Income Strategy
alan.clarke@scotiabank.com

KEY THEMES

The headline grabbers at this Autumn Statement are likely to be:

- **Slippage** — The OBR's borrowing estimates are likely to rise reflecting a combination of worse-than-expected tax receipts so far this financial year, coupled with a downgrading in the growth outlook from 2017 onwards.
- **Government borrowing** is also likely to be pushed higher on the back of discretionary fiscal easing measures.
- We expect the PSNBx for 2016 to be raised by GBP7bn to GBP62.5bn, with 2017's estimate pushed up by just over GBP20bn to GBP60bn.
- Cumulatively, borrowing over the next four and a half years *should* be revised up by up to GBP150bn, although we suspect the extent of the revisions will be closer to GBP100bn…
- …That should not be blamed entirely on Brexit; we think that the previous forecasts for borrowing late in the parliament were overly ambitious.
- We expect the OBR's **GDP growth estimate** for 2016 to be largely intact (at 2.0% y/y), with next year's projection slashed to just above 1% y/y.
- Meanwhile, the OBR is likely to push its **inflation projection** up sharply on the back of the weaker GBP exchange rate.
- The rise in the outlook for inflation is likely to add around GBP4bn to the inflation linked debt interest burden. That will offset much of the windfall from lower gilt yields. Hence the windfall from '**money down the back of the sofa'** is likely to be limited.
- The revised **DMO remit** is likely to show an increase in issuance during 2016-17 by around GBP7bn, which we expect to be absorbed by higher T-bill issuance. Meanwhile the 2017-18 indicative financing requirement is likely to rise by around GBP20bn.
- We expect the **discretionary easing measures** to be dominated by increased infrastructure spending. In addition to that, there is a reasonable chance that corporation tax will be reduced. While it is not our base case, we believe that there is a small probability of a VAT cut.

UPDATED MACROECONOMIC PROJECTIONS

In the past, the logic used to be that the outlook for GDP growth will be the biggest influence on the inflation outlook. However, that has been turned on its head in the current environment. More specifically, the sharp upgrading in the inflation outlook on the back of the weaker GBP is likely to be a significant drag on growth.

Table1: Evolution in OBR Macroeconomic projections

GDP %y/y						
	2015	2016	2017	2018	2019	2020
Likely	**2.2**	**2**	**1**	**1.25**	**1.5**	**2**
OBR (Mar-16)	2.2	2	2.2	2.1	2.1	2.1
OBR (Nov-15)	2.4	2.4	2.5	2.4	2.3	2.3

CPI %y/y						
	2015	2016	2017	2018	2019	2020
Likely	**-0.1**	**0.7**	**2.5**	**2.5**	**2**	**2**
OBR (Mar-16)	-0.1	0.6	1.6	2.1	2	2
OBR (Nov-15)	-0.1	0.6	1.6	2.1	2	2

Inflation: Given the sharp depreciation in the GBP exchange rate over the past 12 months, but particularly since the Brexit referendum, the outlook for inflation has risen substantially. Previously, the OBR's projections had envisaged that CPI inflation would reach 1.6% y/y on average during 2017. We expect that to be pushed up abruptly to around 2.5% y/y on average for 2017. That is an annual average, reflecting inflation close to 2% y/y at the start of the year, and closer to 3% y/y by the end of the year. We suspect that the OBR will project a similar pace of inflation during 2018, before CPI reverts towards the 2% target as the effects of the weak GBP dissipate.

Growth: The OBR's GDP growth projection of 2% y/y for 2016 looks very reasonable and unlikely to be touched. Meanwhile, we expect the OBR to slash its growth projections for 2017, down from 2.2% y/y to 1.0 – 1.5% y/y. That would be broadly in line with consensus. If there is a risk to that forecast, it is that we will see an even bigger downgrade to next year's growth forecast and in turn a bigger drag on the public finances. The main reason for the slowdown in growth next year is likely to be the abrupt increase in inflation eroding household disposable income growth and hence consumer spending. Net trade could prove to be relatively supportive for growth given the imports will follow consumer spending lower and the weak GBP exchange rate should encourage solid export growth.

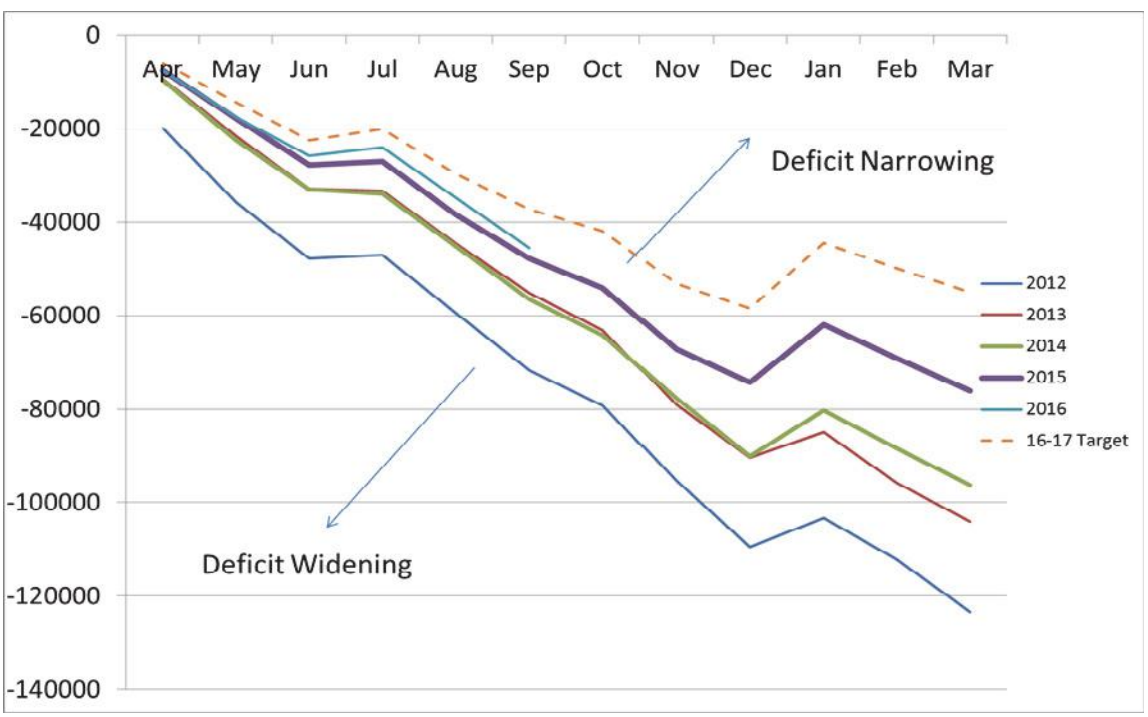
PUBLIC FINANCES PROJECTIONS

- **Slippage / Impact of weaker growth**
  2016-17

The first six months of the financial year have not got off to a particularly good start. The good news is that the level of government borrowing has continued to fall relative to the same time a year earlier. The bad news is that the extent of the reduction in borrowing is running well behind the plans laid out in the spring Budget.

More specifically, during the fiscal year to date, Public Sector Net Borrowing (ex-banking groups) has been a cumulative GBP45bn. That is just GBP3bn lower than over the same period a year earlier. In order to have been on track for the full-year borrowing estimate of GBP55.5bn, year to date borrowing would need to have been GBP10bn lower than a year earlier (Chart 1). To be fair, much of the improvement in borrowing during previous years has come towards the tail end of the year rather than the start. We expect this year's borrowing figure to be around GBP7bn higher than previously projected. That means a full-year PSNBx estimate of GBP62.5bn.

Chart 1: Evolution in the Public Sector Net Borrowing Throughout Recent Financial Years



2017-18

For future years, the key government borrowing projections are likely to rise due to two key influences – further slippage and discretionary fiscal policy loosening. With regards to the former, the biggest reason for slippage in the borrowing estimates is likely to be the substantial downgrade in the OBR's GDP growth projection. Based on the typical rule of thumb, the 1% downgrade that we expect to the growth projection should raise government borrowing by GBP10bn during 2017. For the same reason, borrowing should be around GBP15bn higher during 2018.

- **Discretionary Policy Easing / The Structural Deficit**

When it comes to discretionary fiscal loosening, it is very much down to judgement. The Chancellor has already announced that the government has abandoned previous plans to achieve a budget surplus by the end of the parliament. However, we don't know how generous the Chancellor is likely to be. Given that Q3 GDP was much firmer than expected, there is less urgency to throw the kitchen sink at the economy. The economy expanded by a very respectable 0.5% q/q; a million miles from the zero or negative readings that we feared in the immediate aftermath of the EU referendum. Had the figure been a horror show, then we would have expected an aggressive response. For now, we suspect that the Chancellor will be reasonably restrained in terms of giveaways. This will leave him ammunition in case there is a more compelling case to come to the rescue at the Budget in the spring.

The best way to gauge the extent of any fiscal giveaways is to consider the structural deficit. This gauges the narrowing (or widening) in the budget deficit, stripping out any impact of gyrations in economic growth. In other words it tells us whether fiscal policy is actually tightening or loosening.

The projections from the spring Budget showed that the structural deficit was expected to narrow by 0.8% - 0.9% of GDP for the next 3 years (Table 2). That equates to around GBP16bn per year of fiscal tightening. Bizarrely, the pace of fiscal tightening was then suggested to accelerate to 1.5% of GDP during 2019-20 – just as the next General Election was approaching.

We doubt that the Chancellor will reverse any of the prior tightening in fiscal policy. Rather, we expect the pace of fiscal tightening to be slowed down, or put on hold temporarily. Our guess is that instead of GBP16bn per year of discretionary fiscal tightening, the pace will slow to around GBP5bn per year. Looked at another way, government borrowing will be around GBP10bn per year higher as a result of the more moderate pace of austerity.

Table 2: Structural Deficit Projection (Budget 2016)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Cyc Adj PSNBx (% of GDP)	-3.6	-2.7	-1.9	-1.0	0.5	0.5
1y Chg in Cyc Adj PSNBx (% of GDP)	0.7	0.8	0.8	0.9	1.5	0.0

- **Money down the back of the sofa?**

There are two other, albeit opposing, influences on the borrowing arithmetic. On the one hand, the fall in government bond yields since Brexit has the potential to reduce the interest burden on the public debt. The flipside is that the sharp increase in the outlook for inflation will have the reverse effect – increasing the interest burden on the inflation linked portion of the national debt.

With regards to inflation, there is roughly GBP400bn of inflation linked debt outstanding. With the OBR's inflation projection likely to be shunted higher by around a percentage point, that points to a GBP4bn per year increase in the interest burden and hence government borrowing.

This time a year ago the former Chancellor received a near GBP20bn windfall thanks to a downgrading of the OBR's outlook for government bond yields. More specifically, the BoE Governor announced that the Bank would not begin to offload its holdings of gilts held under the QE programme at least until Bank Rate hit 2%. On the back of this, the OBR adjusted down its profile for gilt yields by around 0.4% each year for the coming 5 years. The windfall was reinforced by a downward revision to the OBR's inflation projection at that time.

Table 3: Evolution in obr gilt yield assumption

Gilt Yields (%)						
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
OBR (Mar-16)	1.9	1.7	1.9	2.1	2.2	2.4
OBR (Nov-15)	2.0	2.1	2.3	2.5	2.6	2.8
OBR (Jul-15)	2.2	2.5	2.7	2.9	3.0	3.1

The slump in gilt yields in the immediate aftermath of the Brexit referendum had pointed to a similar, if not bigger, windfall for the Chancellor. At one stage, UK 10-year yields were as much as 0.8% below the level prevailing at the time of the spring Budget. However, the subsequent rebound in yields that was triggered by the Prime Minister's speech at the Conservative party conference has reversed about three quarters of that fall.

It is important to note that it is not just the current level of yields that matters for the debt interest estimate. It is the assumption about yields in future years too. In this context, the OBR could well be justified in reducing its assumption for gilt yields in future years. In particular, with the BoE engaging in additional asset purchases and the offloading of its gilt holdings likely to have been postponed yet further, the OBR could easily subtract 25 to 50bp from the gilt yield assumption. At the very least that should offset the increased interest burden on the inflation linked portion of the national debt. At best it could even provide a small net windfall for the public finances.

Summing things up:

Table 4 shows how we expect the PSNBx projection to evolve. We expect borrowing for the current financial year to be pushed up by GBP7bn to GBP62.5bn. Meanwhile 2017-18 is likely to see a near GBP20bn upward revision in the borrowing estimate compared with the latest OBR projection.

Further ahead, there is probably a mis-match between what we expect borrowing to be, compared to what the OBR might project. For example, in 2019-20 we expect the borrowing estimate to be GBP50bn higher than the spring Budget estimate. Our rationale is that in a very good year for the public finances, the deficit has narrowed by GBP20bn per year — and that was amid fairly intense austerity. We expect the pace to be more like GBP10bn per year amid slower growth and less intense austerity. That compares to the latest Budget projections that had assumed a GBP30bn reduction in borrowing in 2019-20 — which would be by far the biggest reduction in borrowing throughout this recovery — just ahead of a General Election!

Cumulatively, our projections suggest a near GBP150bn increase in borrowing over the next 5 years. We very much doubt that the OBR will forecast anything like a GBP150bn increase in the borrowing estimate, but you never know. It is important to stress, this upward revision in the outlook for borrowing is not just because of Brexit. Much of the upward revision is due to the previous projections being overly optimistic.

The bottom portion of Table 4 shows the path of borrowing as a % of GDP. Despite what could be an abrupt upward revision in the level of borrowing, the PSNBx as a % of GDP continues on a steady downwards glide-path in our forecast. The previous assumption that a 1% of GDP deficit in 2018-19 would become a 0.5% of GDP surplus a year later was overly ambitious in our view.

Table 4: PSNB Projection

PSNBx (GBP bn)						
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Likely	-76	-62.5	-60.0	-50.0	-40.0	-30.0
OBR (Mar-16)	-72.1	-55.5	-38.8	-21.5	10.4	11.1
OBR (Nov-15)	-73.5	-50	-24.7	-4.7	10.1	14.7

PSNBx % of GDP						
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Likely	-3.8	-3.2	-3.0	-2.6	-2.0	-1.4
OBR (Mar-16)	-3.8	-2.9	-1.9	-1.0	0.5	0.5
OBR (Nov-15)	-3.9	-2.5	-1.2	-0.2	0.4	0.6

GILT ISSUANCE

It has become normal practice at the Autumn Statement for any overshoot / undershoot in borrowing in the current financial year to be soaked up by adjusting T-bill issuance. In this regard, the DMO remit for the current financial year is likely to see gilt issuance left unchanged, with T-bill issuance upgraded by GBP7bn.

The updated DMO remit is also likely to provide the usual indicative financing requirement for future financial years. As we concede above, our view is that a reasonable cumulative increase in the borrowing estimate would be up to GBP150bn, but is unlikely to come through in the OBR numbers right now. Nonetheless, we suspect the increase in the financing requirement for future years to rise by around GBP100bn.

Table 5: Indicative financing Requirement

Mar-16	2017-18	2018-19	2019-20	2020-21
CGNCR	41	32.3	3	17
Gilt Redemptions	79.5	67.3	93.2	85.2
Financing for reserves	6	6	6	0
Illustrative gross financing requirement	126.5	105.6	102.2	102.2
Likely financing requirement	146.5	130.6	132.2	132.2

DISCRETIONARY POLICY MEASURES

Infrastructure spending

By far the most likely policy loosening measure to be announced will be infrastructure spending. The Government has made no secret of its intentions to invest in this area. It is potentially productivity boosting and popular with pretty much everyone. The flipside is that infrastructure spending suffers from long lead times. It can take years for projects to make it from the drawing board to physical completion.

Big infrastructure investment projects are unlikely to be much help in the face of slowing growth next year. Long lead times may be to the Chancellor's advantage — such a policy would have multi-year benefits; providing an offsetting boost to the Brexit fallout which could also last years. A quicker and effective strategy might be focusing on local authority infrastructure projects should the Chancellor desire.

Corporation tax

Two other possibilities include a further reduction in the corporation tax rate or a temporary reduction in VAT. The current rate of corporation tax is 20% and it is scheduled to fall to 17% by 2020. That is already factored into the fiscal arithmetic. According to the Treasury's ready reckoner, any further 1% point reduction in the corporation tax rate would increase government borrowing by GBP2bn per year. There have been some suggestions in the press that the tax rate *should* fall to as low as 10%. At a cost of GBP14bn per year, that would pretty much wipe out the funds available to the Chancellor to spend. We think that a cut towards 15% is more likely. The main motivation for such a move would be to deter any multinational business that is thinking of leaving the UK due to Brexit, from doing so.

VAT

If the Chancellor wants a quick fix to remedy the likely slowdown in growth next year, then a temporary VAT cut is an option. This is a far less popular alternative amongst commentators, but should target the source of pain for the economy next year — namely inflation. A temporary reduction in the main rate of VAT could reduce inflation by close to 1% and the effects would be felt very quickly. So while that isn't enough to offset all of the damage to real disposable income growth next year, it would go some way to anaesthetising the pain for consumers. One of the main downsides to this policy is that it is expensive. A 2% point cut to 18% would cost the Chancellor around GBP12bn — swallowing up the bulk of the cash that he has to play with. This, coupled with the resilience of the economy during Q3, suggests to us that a VAT cut is not likely to happen…at least not right now. If growth has slowed sufficiently by the Budget in the Spring, it may still be an option at that point.

Canadian Lessons?

In the aftermath of the 2008-09 GBP depreciation, coupled with the 10-20% fall in house prices, overseas buyers could pick up a pad in the UK for close to a 50% discount. The situation right now is slightly different since house prices haven't really fallen. Nonetheless, with the pound 15% weaker, there is still the potential for overseas money to pile into the UK housing market. Many people have voiced their dismay about overseas investors crowding out locals, particularly in Central London.

The UK has borrowed a number of ideas from our Canadian cousins and may yet be minded to borrow one of its housing market policies. More specifically, foreigners looking to buy a home in Vancouver face an additional tax of 15%. Arguably, this is a policy that should have been implemented over here many years ago. Nonetheless, better late than never?

Micro measures

One of the criticisms that has been voiced about Brexit is that the UK will suffer from skills shortages if the borders are closed to unlimited EU inward migration. Given this, it would make sense to fund initiatives that help to fill the skills shortfalls. This might include training schemes for the unemployed.

Similarly, leaving the EU, coupled with the sharp fall in the GBP exchange rate suggest that internal trade may increase while external trade suffers. Hence the Chancellor may be minded to provide tools and incentives to facilitate more efficient internal trade.

Fixed Income Strategy (London, Paris)

www.gbm.scotiabank.com