

UK recession likely amid mounting market turmoil

The UK government has U-turned on part of its controversial tax plan but markets are looking for further measures to reduce borrowing requirements over the next couple of years. The prospect of further Bank of England tightening means higher mortgage rates, which coupled with expensive (though capped) energy bills likely means recession



British Prime Minister Liz Truss and Chancellor of the Exchequer Kwasi Kwarteng at the opening session of Conservative Party Conference, London, UK - 02 Oct 2022

Source: Shutterstock

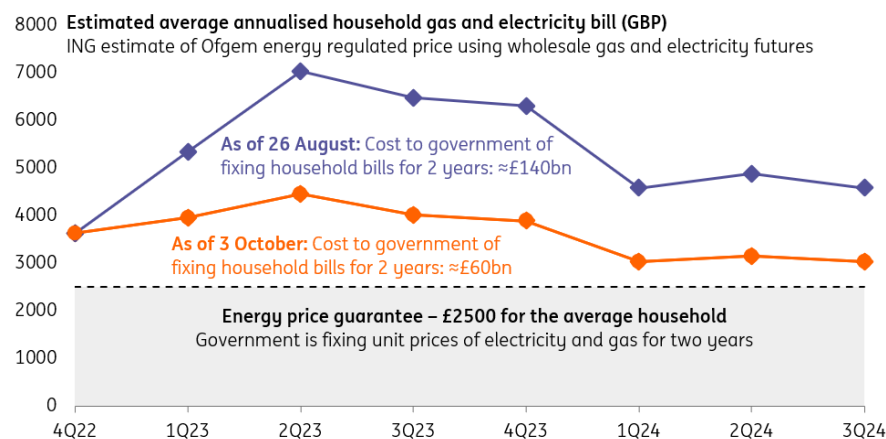
The UK's fiscal event has prompted a wave of volatility in markets

The British government's not-so-mini Budget a couple of weeks ago sparked chaos in UK financial markets. Investors are worried both about the amount of extra borrowing markets will need to absorb as a result of the government's energy price guarantee and unfunded tax cuts, and the inflationary impact and resulting Bank of England reaction. Any resolution to the current crisis needs to be seen through that lens.

The government has since rowed back on a plan to cut the top rate of income tax, and will also

bring forward the publication of its 'medium-term fiscal plan'. The latter likely involves spending cuts to offset the tax rises, and it'll also be coupled with a forecast from the Office for Budget Responsibility. Investors are reading this both as a sign that the government is prepared to compromise in the face of market (and political) pressure, and that it is seeking to restore the role of the UK's independent OBR in the process. The lack of an independent forecast with the mini-Budget had added to investor concerns.

The cost of fixing household energy bills has tumbled - but that could change if gas prices surge once more



Source: Ofgem Methodology, Refinitiv, ING calculations

Without the government's guarantee, the unit prices for energy bills are set by the regulator Ofgem. We have estimated what these unit prices would have been based on wholesale gas and electricity futures now, and as of 26 August when gas prices peaked. The cost to the government is calculated as the difference between these unit prices, and the government's price guarantee (£2500) over a period of two years

Markets want further reassurances on tax cuts and the BoE's QT plans

These are first steps, however, and neither U-turn addresses the central issue for investors described earlier. Scrapping the 45% tax bracket made up only £2bn out of the total £45bn tax cuts package. Spending cuts are likely, but these may prove both politically and practically challenging. Many government departments are already set to face real-terms cuts in budgets while reducing public-sector investment goals looks inconsistent with ambitions to improve the supply side of the economy.

Fortunately, gas futures prices have fallen sharply since August, and the aggregate cost of fixing household energy bills has more than halved. The 'energy price guarantee' will fix the average household energy bill at £2500, which is roughly where it has been since April once additional discounts are added in.

Still, the government may find it needs to look again at a broader windfall tax covering certain types of energy producers – something that is politically popular, would likely raise tens of billions, and would provide a natural hedge should energy prices surge once again (raising the government's bill for capping consumer/business costs).

Our base case for the economy is still recession

For now, some limited order has been restored to both the pound and the government bond (gilt) market – though the latter heavily relies on the Bank of England's verdict on whether to plough ahead with active bond sales later this month, as part of its quantitative tightening process. Together with a decision earlier this year to stop reinvesting the proceeds of maturing bonds in its portfolio, selling gilts would add roughly £80bn of extra supply for the market to absorb over 12 months. In such a volatile environment that's a hard sell – and we suspect the BoE will put its plans to sell gilts on ice for a little while longer.

Higher mortgage and energy costs point to a mild recession

Our base case for the economy is still recession – albeit perhaps a mild one by historical comparison. Despite the mounting fiscal concerns, we shouldn't underestimate the difference the government's energy price cap will make to the outlook. It will save £1500 on average over the next 12 months.

Still, households will still be paying more than twice as much for energy as they were two years ago, and it's a similar story for mortgages. The average monthly payment on a two-year fix looks set to top £1600, up from around £900 in 2020, looking at the current rates available. Households inevitably need to cut back on non-essential spending, and that likely means negative GDP growth rates through the winter.

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