U.K. policy miscues: Let’s not do that again

By Warren Lovely & Jocelyn Paquet

A lot can happen in 44 days, just ask Liz Truss. It took the outgoing U.K. Prime Minister (and her since-departed finance minister Kwasi Kwarteng) no time at all to thoroughly roil financial markets. Much will be written of Truss, a goodly portion likely along the lines of ‘what not to do during a crisis’. We’re not aiming for a soapbox-styled lecture here. Rather, we reflect on Truss’ short, turbulent term in the hopes that other political leaders and fiscal policymakers take heed. The 10 charts and accompanying commentary presented here can’t do the situation justice. Still, selected imagery puts Truss’ ill-fated tenure in perspective, keying as it must on the wrong-headed Growth Plan from September 23rd.

So are you watching and listening Mr. or Mrs. Head of State? How could you not. Has the Truss/Kwarteng carnage registered for you finance ministers? We hope so. There’s presumably a time and place for broad, unfunded fiscal stimulus, but surely not when an economy is operating with little-to-no slack and central banks are engaged in a desperate and credibility-defining fight against inflation. We sympathize with those facing an affordability crisis head-on and concede that targeted relief in some cases makes sense; nor are we ideologically opposed to tax cuts. But count ours among the growing chorus of voices advocating for fiscal restraint, at least until inflation is corralled. As painful as the last few weeks have been, the U.K. lesson must be internalized. We simply say ‘let’s not do that again’. As it happens, Canadian governments have a chance to demonstrate what, if anything, they’ve taken away from the U.K. mess via upcoming Fall Economic Statements. Can’t wait.

Chart 1: Truss will be remembered for all the wrong reasons...
Change in FTSE All-Share Index over UK Prime Minister term

Chart 2: … ditto for Kwarteng, who’s short record simply stinks
Change in FTSE All-Share Index over UK Chancellor of the Exchequer term

Chart 3: To be fair, Truss took over at volatile time but...
FTSE 100 Index vs. other major European/North American equity indices

Chart 4: … policy error fueled anxiety & U.K. underperformance
Absolute & relative change in FTSE 100 Index during Truss term

Anyway you slice it, Truss’ term is/was extraordinary. She goes down as the shortest-serving PM in UK history. Kwarteng, whom Truss tapped as Chancellor when she took office, lasted just 38 days, summarily dismissed in the wake of a disastrous Growth Plan. In the post-war period, only Iain Macleod held the finance post for less time (since he passed away shortly after getting the gig). Using the FTSE All-Share Index (data back to 1962), the Truss/Kwarteng record is as foul as they come. This valuation metric is off an annualized 40% since September 6th, a stain that won’t come out.

It’s not like everything was going swimmingly when Truss took over. The FTSE 100 was off 1.3% on a YTD basis at that point, with investors grappling with raging inflation and the required resetting of monetary policy. But Truss left equity investors with a major hickey in absolute and relative terms, the UK’s bellwether index underperforming key European and North American equivalents. Sad fact: Over £100 billion in FTSE 100 market cap has been wiped out since September 6th. In dollar terms, that’s larger than the annual GDP of 70% of the 190+ countries the IMF tracks.

Source: NBF, UK gov, Wikipedia, Bloomberg | See ‘Notes on charts’ at bottom of page 3
At the heart of this wretched record was the government’s poorly conceived Growth Plan, presented by ex-Chancellor Kwarteng on September 23rd. The reaction was immediate and decisive. Pound sterling—notably one of the most venerable currencies on the planet—was savaged as investors expressed their dismay. Sterling gave up >5% in just two sessions, trading more like an EM than any legit reserve currency. A BoE backstop and subsequent policy reversal spurned a partial recovery, but reputational damage has been done, not just to the currency but obviously in fixed income...

... for it’s in the bond market where disgust has been most palpable and market dysfunction most prevalent. Gilts were violently re-priced on the Growth Plan, 30Y yields gapping from ~3.5% to ~5% and underperforming Treasuries by 125 bps in a first-round selloff. In the height of irony, ill-conceived fiscal stimulus prompted unconventional monetary policy stimulus. The BoE had to rush in to forestall/limit a liquidity event, are clearly dwarfed by earlier QE purchases. The BoE’s temporary long-term Gilt purchases, rushed in to forestall/limit a liquidity event, are clearly dwarfed by earlier QE purchases. Still, the program’s existence highlights structural vulnerabilities in the UK market, prompting an understandable wave of questions about pension system risks in other countries (incl. Canada).

Under pain of political death, Kwarteng had walked things back a touch; not that it saved him. His replacement at Treasury, Jeremy Hunt, has gone further, confirming on October 31st. As per Chart 7, 30Y Gilts are back to trading at relatively tighter levels to Treasuries than was the case before the Truss era, though yields are still higher on balance and markets remain fragile/less-than-fully functional. UK CDS spreads have recovered some ground, but on net, damage has been done to the sovereign.
Market View
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Some concluding thoughts...

There's much to be learned from the Truss/Kwarteng saga and we've only scratched the surface here. Whether the financial and reputational damage to the U.K. credit, the Gilt market and pound sterling can be fully recouped remains an open question. The most offending tax proposals in the Growth Plan have now been nixed, a degree of calm restored (at least relative to the abject dysfunction that characterized currency and bond markets in recent weeks).

We're not necessarily specialists on U.K. politics, but there will clearly be a near-term opportunity for further course correction under fresh Conservative leadership. Voters will ultimately have their say, the next general election representing an even better opportunity to deliver a clear message and mandate to His Majesty’s Government. Stay tuned.

To us, the whole sorry episode highlights, in the starkest possible terms, the potential fallout from so-called 'policy mistakes'. For much of this year, investors have been understandably anxious about a monetary policy mistake. After all, central bankers (in the U.K. yes, but even more so in North America) have embarked on uber-aggressive, ultra-rapid policy rate tightening in the face of broad-based and pervasive consumer price inflation. In hiking so aggressively/rapidly, there's a danger of blowing past the proverbial 'tipping point' for growth, jobs and even inflation. Fair to say there remains a healthy debate (and a lot of underlying nervousness) about when and where that point is reached... if not already. So yes, central bankers are prone to errors and the road that monetary policymakers have placed us on will be bumpy.

But the biggest mistake (at least more recently) must surely be laid at the feet of Liz Truss and her former Chancellor Kwasi Kwarteng. In bringing forward large-scale, unfunded tax cuts at a time when the U.K. economy was undeniably overheated, the Truss government sent all the wrong signals. The rebuke was swift, savage and understandable, the reputational damage severe. To be sure, the financial market fallout from ill-conceived fiscal policy was exacerbated by structural quirks. This was particularly evident in the long end of the Gilt market, where the heavy utilization of LDI investing strategies by the nation’s pension asset managers added a scary dimension to the initial bond market selloff. From all outward appearances, only emergency action by the Bank of England prevented the U.K. bond market from legitimately seizing up. Rattled bond investors have been forced to ask: To what extent do other nations harbour such structural weakness in their pension systems and domestic bond markets? This remains a lively topic of conversation and one we remain heavily engaged in. We’ll happily take it offline with any/all interested parties.

That the Bank of England was called on to clean up the mess by purchasing long-dated Gilts is, if not tragic, then clearly unfortunate. Again, we'll concede that things have calmed down as political heads rolled and policies were walked back, but fragility remains the name of the game in global bond markets. In the here and now, technical and/or fiscal year-end considerations probably aren’t helping, but the biggest problem for the bond market remains red-hot inflation and the monetary policy tightening it demands. Is it too much to ask political leaders and finance ministers to stay out of the way... to not make life harder for central banks by stoking inflation via marginal fiscal stimulus? Surely not. Kwarteng first and now Truss have paid the price for such folly. Let this be a lesson to others.

If there’s some encouraging news, at least in Canada, it’s that our governments generally opted for fiscal consolidation as the recovery took hold. Yes, affordability measures have been outlined and inflation-inspired relief offered up. But the lion’s share of the above-plan revenue booked by federal and provincial governments has thus far gone to the bottom line. That’s meant lower-than-expected debt burdens and less, not more, bond issuance. In other words, the opposite of what the Gilt market came face-to-face with on September 23rd. That said, the rather spendthrift bias demonstrated by many political parties in recent provincial elections proves that we are not immune to fiscal slippage. The spend-your-way-out-of-any-flame, the United States may resist the urge to spend more, but only because political gridlock risks preventing any stimulus packages from going through. Spain is reported to be considering capping mortgage payments; Hungary has already done so. More countries could soon follow. Closer to home, the United States may resist the urge to spend more, but only because political gridlock risks preventing any stimulus packages from clearing Congress before the 2024 presidential election.

We give credit where it is due, but at the same time let us be clear. Canadian federal-provincial governments are advised to avoid broad-based spending increases or tax relief, at least until inflation is genuinely corralled and/or fiscal situations fully remediated. The Bank of Canada will thank you, and in the end, so should most Canadians. On the surface, we’re encouraged by recent comments by Deputy Prime Minister and Finance Minister Chrystia Freeland, who argued (appropriately in our opinion) that big-time stimulus would be akin to “pouring fuel on the inflationary flames and we’d just make the Bank of Canada’s job harder and inflation last longer.” She will have an opportunity to back this up in a Fall Economic Statement, which will also provide an opportunity to signal lower not higher net funding needs. Canada’s provincial fiscal stewards will likewise be in a position to demonstrate what they’ve learned this Fall. It’s surely time to keep one’s fiscal powder dry and we’re hopeful that many (if not all) provinces see it that way too. Can’t say Truss didn’t warn ’em.

Notes on charts:

Chart 1: Based on FTSE All-Share Index data available from 1962 onwards; figures represent annualized percentage change over each prime minister’s term; for example, Truss’ ~40% annualized decline is based on a 44-day change in Index from September 6th to October 20th; Truss’ term is still technically ongoing until replacement named; Wilson was PM for two distinct periods | Chart 2: As with Chart 1, based on FTSE All-Share Index data available from 1962 onwards; figures represent annualized percentage change over each chancellor’s term | Chart 3: Data to 20-October; Fig. US; CdA indices refer to Euro Stoxx 50, S&P 500 and S&P TSX | Chart 4: Figures for Truss term represent change from 6-Sep to 20-Oct; ‘At worst point’ represents peak absolute/relative loss during Truss term | Chart 5: Kwarteng’s Growth Plan was presented 23-Sep; Kwarteng removed 14-Oct | Chart 6: Figures for Truss term represent change from 6-Sep to 20-Oct; ‘At worst point’ represents peak absolute/relative currency depreciation during Truss term | Chart 7: Figures represent relative 30-year government bond yield, expressed as Yield less Bonds/Treasuries/Canada; BoE announced temporary long-term gift purchases 28-Sep | Chart 8: Based on weekly BoE balance sheet; as at 19-Oct; BoE long-term operations included £B56.8bn via Asset Purchase Facility (APF) & £B9.3bn via APF for temporary long-dated UK Government Bond purchases | Chart 9: UK Chancellor Hunt brought forward further Medium-Term Fiscal Plan measures 17-Oct; further changes to fiscal policy are to be announced 31-Oct | Chart 10: Levels relate to 5Y USD sovereign CDS, except US which is based on 5Y EUR sovereign CDS; 29-Sep was widest closing level for UK sov CDS during Truss term; ‘Latest’ refers to 20-Oct
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