Letter n°66

Where is the UK heading?

" Let us free the world from the approach of a catastrophe, laden with its calamities and torments, which the language of men is inadequate to describe"
Churchill's speech in the House of Commons in April 1936.

After 1976, 1992, 2008, 2016, will the country experience a new financial crisis? In 1976, Britain had to resort to the IMF for a loan; in 1992, the Pound had collapsed despite rates raised to 15%; in 2008, it was the global financial crisis and in 2016 the consequences of Brexit.

Today, the country is facing 5 cyclical or structural problems: economic with a low growth in recent years; monetary with the highest inflation of the G7 countries; financial with the risks presented for pension funds and real estate borrowers following the sharp rise in long-term rates; political with an unelected government that defends an unfunded program against the current aspirations and finally trade with the consequences of Brexit.

As this crisis approaches, let us hope that Liz Truss will remember Churchill's words because the world, the financial planet does not need another catastrophe.

- ***The new government's tax cut program***:

In light of the experience of recent decades, tax cuts have not systematically led to a structural increase in the rate of growth, just as tax increases have not necessarily translated into lower growth rates.

The most topical example is, of course, that of the United States because the Reagan income tax cuts did not increase long-term potential growth, and then the removal of tax cuts during the Clinton era did not prevent the economy from growing faster.

In the same vein, while Britain has enjoyed lower tax rates than many continental European countries since the days of Margaret Thatcher, its economic growth and investment rate have not been helped.

Also, Liz Truss's proposal to lower the marginal income tax rate from 45% to 40% was all the less likely to boost growth, especially as rising interest rates penalized home borrowers, reduced confidence and eroded purchasing power.

The government had to abandon the removal of the 45% marginal bracket, but this only represents a saving of £2 billion, or 0.1% of GDP.

The Prime Minister's overall program, £45 billion, 1.5% of GDP, the largest tax cut budget since the early 70s, was unfunded. It provided for a reduction in social security contributions, a maintenance of the 19% corporate tax rate while Boris Johnson had planned to increase it. This program was all the more ill-timed as the government, a few days earlier, had announced a plan of more than £100 billion, or more than 4 points of GDP, to introduce a cap on household energy bills.

As a result, the budget deficit could approach 9%, the trade deficit could be worsened, and the current account deficit could be increased to 10% of GDP.

This neo-liberal agenda does not meet the expectations of a population seeking greater protections, a recovery of the healthcare service and a reduction in inequalities. Let us not forget that Boris Johnson, in a break with the traditional ideology of the Conservative Party, was elected with the announcement of a tax increase in order, in particular, to finance investments in the poor, working class north, a land historically loyal to the Labour Party and for the first time rallied to the Conservative Party.

Today, and this is unprecedented for a long time, the Labour Party leads in the polls with nearly 55% of voting intentions against just over 20% for the Conservatives.

Low structural growth:

Liz Truss's desire to increase the growth potential of the British economy is understandable given the UK's relatively poor performance over the past two decades. However, the program remains inadequate and incapable of restoring confidence, which is key to stimulating consumption because it is unfunded.

- ***Relative decline***:

GDP had recorded a record drop of 9.4% in 2020. It then rose by 7.5% in 2021 but Britain was the last G7 country to return to its pre-COVID GDP, only in the 1st quarter of this year.

Since 2008, average annual growth has not exceeded 1.2%. The country has the lowest productivity because it is in a situation of chronic underinvestment.

More fundamentally, the GDP/hour worked since the late 90s, according to The Economist magazine, is growing at a slower pace than in Germany and France, and Brexit has further worsened the trend due to fracturing supply chains.

According to Martin Wolf, the median gross disposable income, between 2014 and 2018, would have fallen slightly and it would be 9% lower than that of France and 16% lower than that of Germany. GDP per capita, which was 92% of Germany's in 2007, would only be 82% in 2021.

In the 2nd quarter, GDP stagnated, -0.1%, and a decline is expected in the 3rd quarter.

In 2022, disposable income after tax is expected to decline by 3.7%, the worst decline since 1963, according to the Bank of England. Car registrations have fallen from 1.8 million in mid-2021 to 1.5 million, the lowest figure since the late 1970s. And, it is all consumption that should decrease in the coming months.

Fitch anticipates a decline in GDP of 1% in 2023.

- ***Strengths***:

On the industrial front, the United Kingdom maintains certain strengths in the pharmaceutical, defence and aeronautics industries, but all of this has a small knock-on effect on the economy, as industry accounts for little more than 10% of GDP. The trade deficit is very high, £27.9 billion in the 2nd quarter, and over the year it amounts to 8% of GDP.

England's strong positions are still in services. But at the end of this year, British financial institutions will no longer be able to serve European clients from London and will have to do so from subsidiaries based in Europe.

- ***Priorities***:

Today, the country needs investment more than tax cuts or deregulation measures. Regional divides must be reduced, and Boris Johnson understood this. A way must be found to direct part of the £4.6 trillion managed by pension funds to the sectors of the future.

The highest inflation in the G7:

The inflation rate was 10.1% in July, much higher than the 4.7% wage increase, and this difference is provoking many social movements.

- ***Causes***:

In addition to the causes observed in all countries, energy, bottlenecks, etc., inflationary pressures can be explained by, among other things, the low level of unemployment, the difficulty of hiring following the restrictions imposed on immigration during Brexit. It is estimated that there is a shortage of one million workers, mainly in construction, hotels, restaurants and logistics.

Given the recently announced tariff shield, the peak of inflation will be lower than feared but the Bank of England must continue to raise rates.

- ***An upset central bank***:

In September, the official rate, having come from 0.1% at the beginning of the year, was increased for the 7th time from 0.50% to 2.25%, but this is insufficient in view of the inflation figures.

The Central Bank had recently announced a program to reduce its balance sheet to £838 billion (€960 billion) but recent government announcements have thwarted this program.

On the contrary, in response to events, the Central Bank doubled its daily buyback program to £10 billion and agreed to buy inflation-linked bonds to better support the £, to compensate for market dysfunctions and curb the rise in long-term rates. In concrete terms, in the last few days, daily purchases have been approximately £800 million but the 30-year rate is at 4.70%.

Recent purchases by the Central Bank could fuel inflationary pressures as they are similar to quantitative easing.

The next meeting of the Central Bank is scheduled for early November. A rate hike of a minimum of 0.75% is expected and the prospect is for a policy rate of 4.5% in 2023.

Attack on currency and rates:

With Liz Truss's program not being funded, markets are alarmed, the currency is weakening, rates are tightening, the real estate sector is worried and pension funds are weakened.

- ***A weak currency***:

The British currency has long been a weak currency. Let us remember, in 1945, £1 was equal to $4.07, in 1960, the parity had already fallen to $2.80, on the eve of Brexit, it was worse, $1.48 and, recently, following the announcement of the measures of Liz Truss's government, the pound sterling hit a low point of $1.03 and now stands at $1.07.

This depreciation of the £ makes imports more expensive and aggravates inflationary pressures.

The Central Bank has relatively limited foreign exchange reserves to defend the currency, the equivalent of 4% of GDP.

- ***Pressure on rates***:

Along with the downward pressure on the currency, there is pressure on long-term interest rates at 4.64% for the 10-year rate in the session on Thursday, far from the level of 0.7% a year ago, and the expectation of a further hike in a hurry, perhaps even before the November meeting.

This 10-year rate is closer to those of Greece and Italy than those of France and Germany and this is one of the proofs of the handicap presented by Brexit. The country has the advantage of having a very long average debt, 13 years against 6 years in the United States. It is the longest of all developed countries.

- ***The weakening of the real estate sector*:**

Rising mortgage rates threaten the real estate sector. Property prices are still up 9% over 1 year but recently they have started to fall and this is just the beginning.

Mortgage rates were at 1.6% in January, above 5% on Thursday and could reach 6% early next year.

A third of the English population is concerned. 25% of the loans are at variable rates and the others are at fixed rates but for short terms, less than 5 years. Thus, 2.4 million/8.4 million fixed-rate mortgages will mature by the end of 2023.

- ***The weakening of pension funds***:

Pension funds facing liquidity problems are heavily impacted by pressure on interest rates and are sometimes forced to sell real estate funds or bonds, aggravating problems on these products and forcing some funds to block redemptions.

The Lifetime Savings Association manages 30 million people and £1.3 trillion in assets. Also, at the head of the Central Bank, Andrew Bailey is forced to extend purchases beyond Friday, 14 October.

The consequences of Brexit:

A few years after Brexit, there is no sign of increased dynamism because the country lacks manpower and many companies have had to give up exporting to the European Union, despite being their primary market.

- ***The EU, still 1st partner***:

The EU absorbed more than 50% of British exports before Brexit and this has hardly changed.

The Brexit is penalizing exports and the country has still not started deregulation, although this was an important reason for leaving the EU.

In 2021, exports to the European Union were 12% lower than in 2018 and those from the European Union to the United Kingdom 15% lower. On the export side, many British companies are not equipped to carry out all the formalities of access to the European market, a number of English companies have chosen to set up directly in Europe to take advantage of the demand but this is the opposite of the expectations of the supporters of Brexit who thought to repatriate activities.

In the first half of this year, imports from the European Union fell by a quarter because the administrative cost acted as a deterrent.

- ***The Irish Thorn***:

Relations with the EU are bad because of non-respect of the Irish protocol.

Boris Johnson had questioned the customs status of Northern Ireland in defiance of the agreement signed at the time of Brexit and we are waiting for Liz Truss's position on this subject. Following Sinn Fein's victory in the Northern Ireland elections, progress towards the reunification of the two Irelands and the dismemberment of the United Kingdom could eventually accelerate.

Let us recall that the end of the civil war between the 2 Ireland dates back only to 1998 with the "All Saints' Day Agreement" and during Brexit, the attention was to avoid the re-establishment of borders in order to prevent the risk of a resumption of civil war. This border had been established at sea and products destined for Northern Ireland had to comply with European legislation to enter the Republic of Ireland; Boris Johnson signed this agreement but did not respect it.

Port activity is struggling in the United Kingdom while in the Republic of Ireland it has increased by 50% compared to the pre-Brexit level.

- ***The cost of Brexit***:

According to the Office for Budget Responsibility, OBR, Brexit will cut growth by 4 GDP points per year, or \$80 billion/year, simply because many entrepreneurs are not investing due to a lack of visibility. In the 2^{nd} quarter of this year, business investment was still almost 10% below the level of the 4^{th} quarter of 2019.

In Scotland, Sturgeon's government wants a referendum before the end of 2023.

- ***Lack of alternatives***:

During Brexit, the British government had made a point to sign a comprehensive trade agreement with the United States but this does not seem to interest the American government and for the time being, the British have had to settle for an agreement with Indiana.

Elsewhere in the world, agreements have been reached with small markets for the UK, such as Japan (£30 billion in trade versus €700 billion with the EU), South Korea, Australia, New Zealand (0.2% of British trade) and Canada.

Conclusion: ***"This fortress built by nature for herself against infection and the hand of war... this precious stone set in a silver sea"*** Richard II by Shakespeare.

It is difficult to recognize Shakespeare's England in the current tumult. Since the announcement of Liz Truss's program, the stock market has lost some 5%. The dismissal of Finance Minister Kwarteng and finally the reversal of Boris Johnson's decision to increase corporation tax from 19 to 25%, a measure that Liz Truss wanted to cancel, may calm the market for a while but £25 billion in tax breaks remain and they are not financed. Uncertainty should prevail and the continuation of Liz Truss does not seem assured.

The IMF and Moody's are worried about the UK. S&P is downgrading Britain's rating from AA stable to AA with a negative outlook and, in short, to stop this crisis, the government would have to abandon this unfunded relief program.

In the current climate of currency and interest rate pressures, it will not be easy for the Central Bank to stop its interventions, but in doing so it contradicts its objective of reducing the size of its balance sheet and fighting inflation, which is higher than elsewhere among the G7 members.

A lesson to be learned for investment strategy and market evolution is the attitude of the Bank of England which between the two evils of inflation and the financial crisis or recession, it is more concerned with the latter. In other words, the Central Bank is not completely free to move to counter inflation or is willing to tolerate more inflation.

More fundamentally, we can repeat the words of our introduction in Letter 44 in November 2021 "for the United Kingdom, it is a costly mistake; for the EU, it is a political disappointment because the United Kingdom shares the same democratic values as the countries of Western Europe and, on the other hand, the economic opportunity for a deepening of the Union that was systematically blocked by the British."

Geneva, 17^{th} October 2022

Bruno Desgardins

Bruno Desgardins
CIO
Switzerland

SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@singalliance.com

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@singalliance.com

SingAlliance (Hong Kong) Ltd
Unit 904-907, 9/F Dah Sing Financial Centre
248 Queen's Road East
Wanchai, Hong Kong
T: +852 9685 9300
E: info.hongkong@singalliance.com

SingAlliance Pte Ltd
(DIFC Representative Office)
The Gate, Level 13 East, Office 10, DIFC
PO Box 121208 Dubai, UAE
T: +971 (0) 4 401 9158
E: info.dubai@singalliance.com