

## Market Insight

### As bad as it gets?

Today, George Osborne produced the most fiscally austere and severe budget in post-war UK history. The UK is embarking on its sharpest budget deficit reduction crusade since the 1940's with the aim of cutting the structural deficit by 8% of GDP over the next 5 years and reducing the fiscal deficit from 11.1% of GDP in 2009/10 to 4% in 2014/15.

Market reaction has been positive so far with Sterling rising and UK bond markets also received the budget with confidence – yields on long-term UK government debt moved lower following the Chancellor's speech.

The rise in VAT to 20% and a pathway for consecutive decreases in corporation tax are the main features of the budget that should help UK markets. Although the rise in VAT will put further pressure on inflation measures and inflation expectations, the revenue generated allows the coalition government to avoid many of the deeply unpopular cuts to social welfare and healthcare budgets. The progressive reduction of corporation tax should act as an incentive to invest in the UK and thus increase capital inflows over the next five years.

Aspects of the budget that market participants felt was a threat to the UK recovery and UK asset classes in general were the lower GDP growth projections over the next two years. Previous estimates in the March budget and from the Institute of Budget Responsibility (iOBR) have been revised lower; down to 1.2% in 2010 and 2.3% in 2011. The severe cuts to public spending are likely to weigh on economic output for the UK as a whole and does create the possibility of further budget cuts and more tax rises at a later date should economic growth fail to meet current projections. It is important to note that fiscal austerity is directly correlated to growth. If GDP estimates are revised lower and/or actual GDP growth rates undershoot projections, the size of the fiscal adjustment will increase in real terms.

The key indicators for continued recovery and what investors will be scrutinising over the medium-long term is whether government borrowing figures, GDP growth rates and in turn, budget deficit figures meet the sanguine expectations set by the Chancellor. We're not out of the woods yet but at least the international capital markets have received this emergency budget with relative confidence which should induce a gradual inflow back into UK assets over the course of 2010. The UK remains heavily indebted while the path to fiscal balance is drawn out and faces several risks given the fragility of the broader global recovery. Overall, it was a strong budget that has removed a lot of uncertainty and appeased the bond markets for the time being, although the prospect of the UK returning to a sound fiscal footing within the next 5 years is far from certain.



#### Market Research

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