Bretton Woods Research, LLC

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The Battle for Britain & a Mexico 1982 Moment?

- BOE breaks ranks, intervenes pledging unlimited bond buying to avert crash
- Popular reportage wrongly links UK financial distress with Truss-Kwarteng tax-cut plan
- Pressure on Truss government to rescind tax cut plan includes IMF
- If 10 Downing holds fast, UK should outperform
- BOE move potential turning point with central bank hawkishness, globally

In a bid to avert a crash in UK financial assets, the Bank of England pledged unlimited bond-buying this morning and the move is making waves, globally. The UK 30-year yield dropped more than 100 basis points, to 3.98%, the biggest daily drop ever.

Already, the implied Fed funds rate for May 2023 has dropped to 4.48% from 4.55% yesterday. Meanwhile, the US 2-year yield has dropped more than 12 basis points to 4.1575%. The US 10-year yield is down to 3.76%. The dollar-gold price is up more than $25, to ~$1655/oz.

This might be like Mexico 1982, in terms of breaking the hawkish fever of major central banks which had been sending equities and bond prices lower.

At 6am ET, the BOE submitted its statement on intervention noting that it was continuing to monitor "the significant repricing in UK and global financial assets." It conveyed that in the UK situation "were dysfunction in this market to continue or worsen, there would be a material risk to UK financial stability. This would lead to an unwarranted tightening of financing conditions and a reduction of the flow of credit to the real economy."

It then affirmed that it would be conducting temporary purchases of longer-term bonds (gilts) "to restore orderly market conditions."

"The purchases will be carried out on whatever scale is necessary to effect this outcome."

According to Bloomberg, the BOE believes it had just hours to act as concerns were that collateral requirements on liability-driven investment strategies, such as those operating at pension funds, would have turned many into forced sellers of long-term bonds. The BOE also canceled its speech on balance sheet reduction, scheduled for tomorrow.

A lot of financial press reportage, much of it sympathetic to Labor and hostile to conservatives, that the tax cut plan of Truss and Chancellor of the Exchequer Kwasi Kwarteng had amounted to a risky scheme responsible for sending yields off the races and the pound to new lows against the dollar.

We disagree with such analysis. Rather the death march of central banks communicating ever higher rates of interest for the world economy was worsening the growth outlook for much of the developed world. Meanwhile, the strong dollar phenomenon, which accompanies an international rush for dollars when global investors sense an imminent contraction, has been felt in other currencies as well, such as the euro, yuan, and yen. The pound is not an outlier in this regard.

The Truss-Kwarteng tax plan is pro-growth and cuts a clear path out of the austerity jungle Johnson`s government found itself in under the direction of Rishi Sunak. Specifically, Truss-Kwarteng would:

- Scrap Rishi Sunak`s planned increase to the corporate tax rate to 25% on April 2023 from 19%
- Scrap a 1.25 percentage point increase in National Insurance Contributions (a tax)
- Scrap Boris Johnson`s 2.5 percentage point increase in the payroll tax
- Reduce the top marginal rate to 40% from 45%; mid-range rate to 19% from 20%
- Make permanent, the temporary de facto expensing of up to £1mln for businesses

But the Labor-leaning press has been on constant attack, trying to get Truss and Kwarteng to fold on their tax plans. Even the Guardian was reporting that dissent among Tory MPs are reaching new heights. Some unnamed quotes, “They have blown the bloody doors off the economy. I have no idea how they are going to carry on now.” Another added: “Kwasi will have to go. She won’t have any option, they are actually crashing the economy and she will need somebody to blame.” This is all a misread of the current financial distress that the current rate-hiking campaigns of the Fed, ECB, BOE, et al are creating. If anything, the Truss-Kwarteng plan would allow the UK to weather the storm better than its peers.

Still, credit ratings agencies are gunning for Truss-Kwarteng. Moody`s concluded this week that the plan was "credit negative." But this is wrong. By encouraging growth and production, the plan actually enhances the UK`s ability to service its long-term debt.

The current battle for Britain -- between the forces of growth and the forces of austerity -- reminds us of the full court press conducted on the pro-growth plans of Hungary`s Viktor Orban since the European Debt Crisis in 2010. Between the IMF, ECB, credit rating agencies, and financial press, it seemed everyone outside of Budapest for several years hoped Orban would abandon his tax cut plans for more austerity. Instead, he held fast. The performance differential between the Greek and Hungarian experience was no contest. Between 2010 and 2015 Hungarian equities fell 28% in USD terms, while Greek equities fell 78% in USD terms. Meanwhile, unemployment in Hungary fell to 6% from nearly 11%, while Greek unemployment rose from over 11% to 24%.

For its part, the BOE has promised to stay on the attack with rates. Even in its statement this morning, "The MPC will not hesitate to change interest rates by as much as needed to return inflation to the 2% target sustainably in the medium term, in line with its remit." Just like the Fed, it wrongly believes the path to lower interest rates is through reducing demand, risking recession. Perhaps with the financial risks creeping higher, there will be a pause in the making.

Treasury Secretary Janet Yellen`s comments on September 27 that markets were functioning well and conditions were "not disorderly," follow new reports that she`ll exit the Biden administration in January. For now, we view the BOE move as a clear shot across the bow of the Fed.

If the BOE was truly hours from a massive crash, the subtext is clear, others are very likely facing the same uncertainty. It is reasonable to believe other central banks are now reexamining their assumptions about financial stability under more rate increases that only promise more contraction.

Bottom line: If Truss and Kwarteng hold fast (and we've reached the apex of Western central bank hawkishness), UK equities should easily outperform much of Europe within twelve months.

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