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COULD RACHEL REEVES BE A 'LUCKY GENERAL'?

Will fortune favour the Chancellor – and investors in the UK?

This is a marketing communication.

As the effects of the Autumn Budget ripple through the economy, the government may be forced to renege on election pledges. But now that bad news is good news again, fortune may favour the Chancellor – and investors in the UK.

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The trouble with quotations is that they're often misattributed or even made up. Napoleon is a case in point. According to legend (and the internet), the Corsican commander said, "Give me lucky generals". Alas, there's no evidence of any such utterance. The preference for luck over skill in military command seems to have originated with Cardinal Mazarin, a seventeenth-century papal envoy.[1]

But the sentiment has survived over the centuries because it underscores an essential truth – that sheer luck often plays a greater part than individual agency in determining success or failure.

The Budget, bonds and employer costs

That brings us to Rachel Reeves, the Autumn Budget and the UK's economic outlook. Three months on, we'd struggle to say that October's Budget has been a success.

Recently, we've seen turmoil in the bond markets, with yields spiking on long-dated UK gilts. To explain this, many have pointed to April's introduction of certain Budget measures and their potentially inflationary effects.

These include the higher business costs entailed by rises in employer National Insurance contributions (NICs) and the National Living Wage (NLW). Some investors worry that higher employer costs will prove inflationary, accelerating the rapid wage growth of recent months.

But higher employer taxes will hit business hard. A recent trading statement from retailer, Next, sets out the expected impact: a 10.2% increase in the cost of employing most full-time retail workers and a 13.2% increase in the cost of part-time employees.[2]

That's a tough scenario for employers large and small. The overall effect will be a fall-off in job vacancies – and a slump in employment. Rather than accelerating wage growth, the Budget looks set to choke off job creation. And the hit to profits will affect the full range of corporate spending: investment, advertising and production, along with headcount.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed here were, or will prove to be, profitable.

[1]Source: The Independent as at 25 August 2017. *The Top 10: Misattributed Quotations*

[2]Source: Next as at 7 January 2025. *Q4 2024/25 Trading Statement (Christmas)*

Inflation on the way out?

This comes at a time when inflation is already quiescent. The latest Consumer Prices Index is down from 2.6% in the 12 months to November 2024 to 2.5% in the 12 months to December.[3] Meanwhile, figures from the Office of National Statistics show that unemployment is falling – but so are job vacancies. With more competition for jobs, employers don't need to make wages more attractive.

But we expect an even sharper slowdown soon. Collectively, retail, hospitality and leisure employ about 20% of the population and account for around 25% of vacancies. These sectors pushed up wages and inflation as Christmas approached. With the festivities behind us, this effect should soon wear off. And these sectors are among the most exposed to the Chancellor's changes, given the large number of employees on the NLW.

So as seasonal effects combine with higher employment costs, job vacancies should drop off. Meanwhile, other inflationary indicators are increasingly benign, rentals aside.[4,5]

The grim employment picture is already visible in the data. Take the latest report on jobs in the south of England from KPMG and the Recruitment and Employment Confederation (REC). It reports a "pronounced drop in recruitment activity" in December, with starting salaries falling at the fastest rate since February 2021.[6]

There is more to come. As higher employer costs feed through into the data, people will see that the UK no longer has an inflation problem. Instead, it has a growth problem.

Uncertain income

That's not all the bad news. Recent GDP data shows a flatlining economy, with zero growth in the third quarter of 2024. And, as the latest outlook from the Office of Budget Responsibility (OBR) makes clear, the government's tax-raising measures are likely to fall short.[7]

The OBR categorises 13 measures from the Autumn Budget as having "high" or "very high" uncertainty over their costings. The most lucrative should be the tighter regime for non-domiciled taxpayers. But the OBR says that the £13 billion in projected revenue over the next five years is highly uncertain; when it comes to tax regimes, non-doms can vote with their feet. Government receipts from the changes to inheritance tax are similarly uncertain, given scope for creative estate planning and increased gift-giving.

So, with wage pressures abating sharply, a slowing economy and uncertainty over tax revenues, the government will come under severe pressure to cut costs or raise additional taxes. The tax shortfall will only hit hard in 2026. But spending is already tight, and defence and the NHS are ringfenced as they were under the Conservatives. Reeves will have to look elsewhere for cuts: to the Home Office and the overseas aid budget, for example. But with little room for manoeuvre, taxes will almost certainly have to go up.

Corporate tax is a no-go: companies are already squealing under the strain of the National Infrastructure Commission (NIC) and National Living Wage (NIW) reforms, and Labour has ruled out main-rate changes. So the only real options are targeted taxes on 'bad' industries (a tricky proposition) or a rise in the main rate of income tax. We think it's going to be the latter – or, perhaps, a rise in VAT. Labour ruled both measures out in its manifesto, but the government is going to have to do it anyway.[8] And that will depress the economy further.

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[3]Source: Office for National Statistics as at 15 January 2025. *Inflation and price indices*

[4]Source: House of Commons Library as at 15 January 2025. *Inflation in the UK: Economic indicators*

[5]Source: Office for National Statistics as a 16 October 2024. *Private rent and house prices*

[6]Source: S&P Global, KMPG and REC as at 9 January 2025. *https://www.pmi.spglobal.com/Public/Home/PressRelease/dbd04a2e26084335b56b784b17d46b68*

[7]Source: Office for Budget Responsibility as at 30 October 2024. *Economic and fiscal outlook – CP 1169*

[8]Source: Institute for Fiscal Studies as at 21 September 2024. Delestre, I. (2024). *Options for increasing taxes*

Bad news is good news

That means we'll have no shortage of bad news in the months ahead. But we're back in that topsy-turvy world where bad news is good news. As in the wake of the global financial crisis, every downward lurch in data will spur the Bank of England (BoE) to do what it can to arrest the downturn and promote growth: in short, to slash interest rates.

We think the BoE will go further than investors currently expect. We expect between 100 and 150 basis points of rate cuts this year. Even then, 3.75% or 3.25% still leaves the Bank Rate with further room to fall.

This is where luck comes in. Despite all the gloom, the UK consumer is still in decent shape, with household savings healthy.[9] Along with higher unemployment, these are exactly the conditions the BoE needs to cut rates more aggressively, giving the UK economy – and investors – a shot in the arm.

Andrew Bailey, the BoE's governor, has already signalled that the Bank may adopt this approach. And that's why Rachel Reeves could prove a 'lucky general'. As the BoE responds to economic misery by slashing rates, it will stiffen the backbone of British business and raise the animal spirits of investors. Bad news is good news – so there's plenty of both to come. You can quote me on that!

[9]Source: Office for National Statistics as at 23 December 2024. Households (S.14): *Households' saving ratio (per cent): Current price: £m: SA*

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