

MARKET COMMENTARY

Success of BoE's measures to calm markets hangs in the balance

Author: Christoph Siepmann

September 29, 2022

- Yesterday, the Bank of England (BoE) revived its bond-buying programme in an [emergency move](#) to protect pension funds. The move follows market turmoil after last week's announcement of the new finance minister (Chancellor of the Exchequer) to cut taxes, implying a large rise in the government deficits over several years.
- The [BoE purchases](#) are limited to above 20 years residual duration but principally unlimited in scale (but the BoE has indicated buying GBP 65 bn, i.e. 5 bn /day over 13 weekdays). The Bank's press release noted the purchases could run until October 14. The BoE also said it would postpone the start of its bond selling programme of about GBP 80 bn/year, which had been due to begin next week. For the time being, it thereby de-facto accommodates the fiscal move.
- This morning, PM Truss defended the tax cuts announcements from Chancellor Kwarteng, aiming at pushing the UK economy on a higher growth path. She is quoted as saying that "*This is the right plan that we've set out*". But the government will also stick to its plan to hold a fuller fiscal announcement on Nov. 23. The plan may contain laying out how to consolidate public finances, but Truss' announcement suggests no taking back of the fiscal programme, at least in principle..
- We share the widespread criticism that currently expansionary fiscal policy is counterproductive to the efforts of central banks to tame inflation. However, it looks that the clash between fiscal expansion and monetary tightening will take more time to be resolved. This is a very unfortunate situation. As a consequence, markets will remain on alert, despite the central bank efforts to protect financial stability. The policy inconsistency may prove especially toxic for the pound amid the rising current account deficit.

In our view, the current market turmoil has been sparked by the clash in monetary and fiscal policy. On top of PM Liz Truss' announcement of a cap on household's energy price bills over two years and for firms for six months, her Chancellor laid out a large tax cut programme, in order to put the UK on a higher growth path (targeting 2.5%). The package includes income tax cuts, the reversal of last April's rise in National Insurance tax, the cancelling of next April's rise in corporation tax and a cut to stamp duty and other measures. Together, it could lead to a rise of the government deficit to around 9% in FY 22/23 (numbers differ as the amount of gas subsidies depend on the future market prices) and may reach still about 3.5% in FY24/25. There was no other plan than to finance the deficit by issuing debt.

At the same time, given the high inflation of close to 10% yoy, the BoE is tightening monetary policy and thus aggregate demand. It raised Bank Rate to 2.25% last week and also announced to start Quantitative Tightening (QT) by GBP 80 bn per year. QT is limited in size as the BoE's holdings are GBP 1.2 tr. However, this supply would come on top of government issuance. The market considered the fiscal announcement to be a risky "gamble" and responded with a strong drop of the British pound, temporarily to historical lows against the dollar, and strongly rising Gilt yields (temporarily by about 100 bps for the 10y tenor) amid a high volatility. The strong moves at the long end of the curve threatened to badly damage the financial health of defined benefit pension plans, as plan managers would have been forced to sell their long-term assets to ensure their schemes would still be viable (for details see [here](#) and LDI aspects [here](#)). This could have easily ended in a negative spiral that the BoE prevented.

The BoE's recent measures are an emergency action as it is responsible for market stability. However, the underlying conflict of monetary tightening and fiscal expansion is not resolved. If PM Truss was unwilling to scale back her fiscal stance, this would force the bank to raise interest rates even more strongly to overcompensate the government's stimulus and to bring inflation down. The IMF said that "*it is important that fiscal policy does not work at cross purposes to monetary*

policy" and called on the UK government to "re-evaluate the tax measures, especially those that benefit high income earners". Thus, hopes are on November 23, when the Chancellor is expected to make his next budget announcement. The market expects the government to scale back, reduce the implied inequalities of the tax cuts, so that the BoE could return to its tightening policy. Moody's warned the UK that unfunded tax cuts are 'credit negative'.

Nevertheless, PM Truss has a reputation of not calming conflicts. She also announced during her campaign to look into the BoE's remit. Thus, we do not expect monetary and fiscal policy to agree easily on a common stance. Before such a stance would become visible, more market turmoil may be the consequence despite the emergency measures of the BoE.

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein provided. Generali Insurance Asset Management S.p. A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website www.generali-investments.com. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..