

Budget Holds Few Surprises for Markets

A summary of the main points from the budget:

- Economic growth forecasts revised down to 1.2% this year and 2.3% next year. During 2012, the government expects growth to increase to 2.8%, then to 2.9% in 2013 and 2.7% in both 2014 and 2015.
- Public sector net borrowing forecast to be down to £20 billion in 2015-16 (1.1% of GDP) from £149 billion this year (10.1% of GDP).
- Overall debt levels to peak in 2013/14 at 70% of GDP.
- Spending cuts of 25% for most government departments, public sector pay freezes, pension reviews, caps or freezes on certain welfare benefits.
- Corporation tax, currently 28%, to fall by 1% a year for four consecutive years until it reaches 24%.
- VAT to increase from 17.5% to 20% on 4 January 2011.
- Capital gains tax, currently 18%, to increase for higher earners to 28% from midnight. No changes to 18% rate for low and middle-income savers.
- Levy on mid and large sized UK banks and the UK operations of foreign banks from January 2011.

The measures to cut spending and increase taxes had largely been anticipated by investors, and while reaction was broadly positive, it was muted. There were no big surprises to this budget but it should have worked to ease fears in the market and act to please the ratings agencies. However, tough decisions as to how the departmental spending cuts will be achieved still lie ahead.

In fixed income, the Debt Management Office (DMO) released a statement following the Chancellor's budget statement, detailing that they will issue £20.2 billion fewer bonds than expected during the 2010/11 fiscal year, taking total issuance down to £165 billion. While the cut in issuance was expected, if a little bit less than the £25 billion the market was looking for, the DMO also released details of where issuance would be focused. It had been expected that the cut in issuance would be focused on medium and long-dated conventional gilts and index-linked gilts rather than short-dated bonds. Yields in short-dated bonds are very low due to strong demand generated by the bank solvency requirements as well as overseas demand. However, the reduction was fairly evenly spread across the curve (details in chart below).

Split by maturity and type £bn	Reduction £bn	New Plan £bn	%
Short-dated conventional	-6.4	52.6	31.9
Medium-dated conventional	-4.7	38.2	23.2
Long-dated conventional	-4.9	40.4	24.5
Index-linked	-4.2	33.8	20.5
Total	-20.2	165.0	100

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Gilts had been rallying for some time ahead of the budget announcement, outperforming German bunds. Overall, bond markets began by rallying during the Chancellor's speech, with the yield on the 10-year bond falling to as low as 3.41% 20 minutes into the speech. However those gains were reversed over the next hour with markets mildly disappointed - probably as a result of being so bullish going in.

Intra-day changes for the UK 10-year gilt yield (Source: Bloomberg)



Insight's View

The budget does little to change our view for either gilts or sterling. We believe that measures in this and future budgets will address rating agencies' concerns for the safety of the AAA rating and that fears of prolonged high levels of gilt issuance have been assuaged. Indeed, we believe that the market will start to price in an interest rate rise for early 2011, something that in the current crisis is simply not on the market's mind.

In parallel, we believe sterling will remain weak for some time. Spending cuts will reduce demand in the economy and allow interest rates to remain lower than they would under the previous administration's plans. This mix of tight fiscal policy (positive for sterling) and loose monetary policy (negative for sterling) means investors will have to remain patient for a good while longer before seeing a more positive outlook for the UK currency. The positive aspect is that action taken to reduce the deficit has been taken mostly via spending cuts rather than increased taxation, and this should lead to a higher potential growth rate and a lower risk of a fiscal/sterling crisis. However, there is a great deal of policy credibility priced into sterling already. All of sterling's gains versus the euro since the start of the year are as a result of a shift in relative perceptions of fiscal and economic vulnerability and not because of expected changes in relative monetary policy.