

What's Hot: Chaos hits UK markets

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UK markets are in a spot of bother.

What happened?

On September 23rd, Britain's new chancellor Kwasi Kwarteng unveiled a new fiscal statement. The stated aim of the policy was to generate growth and control inflation. Among the key components was a plan to spend £60bn in the six months from October to reduce household energy bills. This was accompanied by both income and corporation tax cuts. To fund the fiscal gap created by these two moves, the government will need to borrow an additional £70bn by the end of the year and more in the year to come.

The reaction from markets

Market's reaction to the statement was decisive and widespread. Markets appear to be showing almost no confidence in the fiscal plan's ability to pull the UK out of a precarious economic situation.

It started with the currency. The sterling has dropped to its lowest level ever against the dollar (down 20% year to date as of 28 September 2022). Acute volatility has also been seen in gilt markets since the statement where the 2-year gilt yield has surged to 4.3% (as of 29 September, up from 3.0% at the end of August).

Source: WisdomTree, Bloomberg. Data from 4 January 1971 to 28th September 2022.

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The reaction in equities further reveals market sentiment. Historically, UK's FTSE 100 Index tends to benefit from sterling depreciation, given a large proportion of revenues for FTSE 100 companies come from abroad. Not to be this time, though. The FTSE 100 Index has slid alongside the pound.

Even the International Monetary Fund (IMF) came out on the 27th September with a scathing statement on UK's fiscal plan, saying, "Given elevated inflation pressures in many countries, including the UK, we do not recommend large and untargeted fiscal packages at this juncture. It is important that fiscal policy does not work at cross purposes to monetary policy."

Response from the Bank of England

On Wednesday, 28 September, the Bank of England (BOE) unleashed an unexpected £65bn bond-buying programme to calm markets. This emergency quantitative easing (QE) move from the central bank comes at an interesting time when the BOE is looking to tighten policy through higher interest rates to control

inflation but easing policy through bond purchases to calm the markets. The reason for this juxtaposition is that the Financial Policy Committee at the BOE were worried about a complete meltdown of final salary pension schemes which use Gilts in their Liability Driven Investment (LDI) approaches. Meanwhile, the Monetary Policy Committee – charged with keeping inflation in check – has been raising interest rates after inflation had reached double-digits in the summer (and is widely expected to return to double-digits again). The injection of such a large QE will clearly make the Monetary Policy Committee's job harder.

What happens next?

For the volatility to settle, markets will need clarity. This means transparency from the government on how it realistically aims to deliver on its fiscal ambitions. And communication from the central bank on monetary policy. Surprise moves from either may be perceived as panic among policymakers, which could add to the market turmoil.

The Bank of England's monetary policy committee will next convene on 03 November to discuss interest rates (unless it decides to hold an emergency meeting earlier). The next inflation print is expected on 19 October, at which point markets will update their expectations for the central bank's November meeting.

This means there could still be plenty to look out for in the coming days and weeks.

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