

September 2024

Budget Pain Ahead, But Calm Returns to Markets

“Things will get worse before they get better,” Keir Starmer said in a speech on 27 August as he warned “tough action” will be needed to fix the foundations of the UK. The Prime Minister was laying the groundwork for the upcoming Budget which is likely to include some unpopular measures designed to plug a ‘£22bn hole’ in Britain’s balance sheet.

The Chancellor of the Exchequer, Rachel Reeves, will present the autumn Budget on 30 October. She is expected to announce changes to the tax regime, notably inheritance tax and capital gains tax. This will be accompanied by a full fiscal statement from the Office of Budget Responsibility (OBR).

We’ll update you on any policy changes and their implications for your financial plan as soon as they are confirmed.

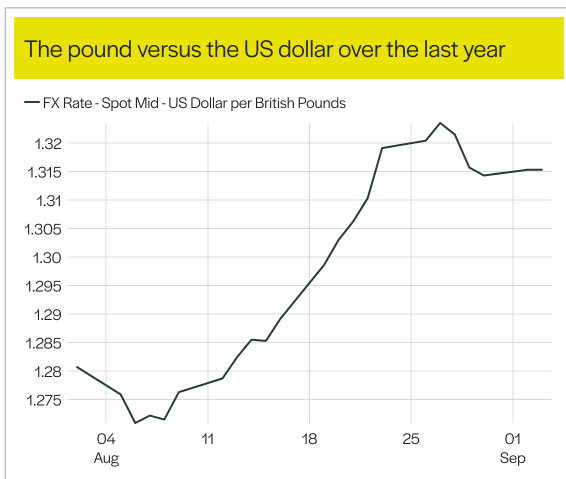
This article considers the economic ‘big picture’ and puts market movements into context. By looking at movements in the Pound, for instance, we can get a sense of how investors are reacting to the negative tone coming from Downing Street.

The Pound (GBP) relative to the US Dollar and the Euro can be an interesting bellwether for the performance of various parts of the UK economy, both in its own right and relative to other major advanced economies. Overall, GBP is driven by an intuitive and complex set of interactions between UK trade with other countries, capital flows, interest rates, inflation, and growth.

Where do Sir Keir Starmer’s comments fit in? Government tax and spending policy can directly affect trade, capital flows, and growth. It does this by changing the spending behaviour of households and companies, and the investing behaviour of financial institutions. This can have a knock-on effect on inflation and interest rates and is, by extension, an important driver of GBP.

Sterling appreciated significantly in August relative to the US Dollar, we think largely due to better-than-expected growth in gross domestic product (GDP). UK GDP is estimated to have increased by 0.6% between April and June, following an increase of 0.7% between January and March.

GBP vs USD



Source: FactSet

There has been little movement in the Pound around Starmer’s speech, however, despite his guidance on higher taxes. We can conclude that, for now at least, financial markets are not focused on the Budget, or they see the potential impacts on the wider UK economy as relatively limited compared to other private sector and global drivers.

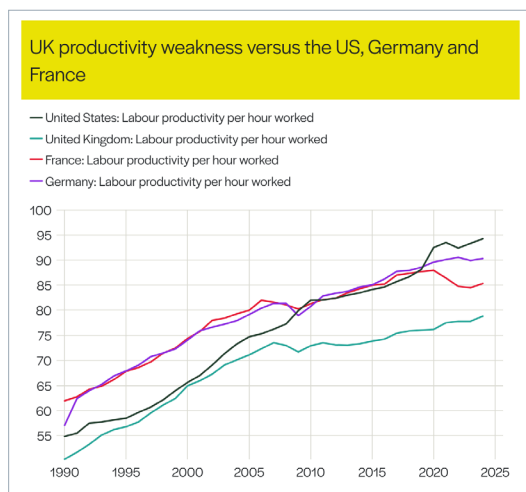
The UK’s Low Labour Productivity Growth

The day after his downbeat speech, Sir Keir Starmer travelled to Germany to meet with Chancellor Olaf Scholz. His aim was to start to ‘reset’ the UK’s relationship with Europe four years on from Brexit. The two leaders discussed a new treaty likely focused on defence-related issues, foreign policy co-operation, and movement of people between the two countries. The Manager think it is less likely to deliver anything substantive on trade which would meaningfully change the UK’s economic relationship with Germany, its second-largest trading partner.

Strong trading relationships are important. They help to support investment, while exports can also build economic diversification and resilience. This is especially important for the UK, which has experienced low levels of productivity and productivity growth for the last 15 years.

Looking forward, labour force growth is likely to slow. As the UK population ages, productivity growth becomes ever more important for future economic growth and living standards.

We can see from the chart below that the UK has experienced almost two decades of weak productivity growth relative to other major advanced economies such as the US, Germany, and France.



Source: FactSet

Productivity growth in this case is measured as GDP or output per hour worked. The reasons for the UK’s ‘productivity puzzle’ are complex, but can be boiled down to three factors.

Firstly, the chart shows a big negative impact on UK productivity between 2007 and 2009. This can be explained by the global financial crisis and its impact on productivity growth in the financial sector. Before 2007, high levels of leverage generated a lot of growth, with deposit and loan volumes growing quickly. After the crisis, lower leverage has been an important contributor to reduced productivity.

Secondly, from 2010, public and private sector capital investment in equipment and structures was relatively weak, contributing to slower productivity growth. Uncertainty and transition costs linked to Brexit may also have had an impact.

Finally, the flip side of lower investment in capital was a period of high employment growth, as firms chose to increase output capacity through hiring lower cost workers instead.

If these are the main reasons for the UK’s extended period of weak productivity growth, what are the potential solutions? Higher rates of government spending on infrastructure and housing, stronger trade ties and support for exporting companies, and new generation technologies such as artificial intelligence. None of these are quick or easy remedies.

Markets Bounce Back After August Panic

Some calm has been restored in stock markets following a sharp rise in volatility in late July and early August. The falls in the S&P 500 from mid-July to the first week of August ended one of the longest consecutive periods of gains for US equities in the last 20 years.

This surge in volatility was mainly driven by a rapid unwinding of leveraged global trades, with investors borrowing in low-interest-rate currencies like the Yen to invest in assets they expect to produce high returns, including global equities. US large-cap tech stocks and Japanese equities, which have performed strongly this year and were popular leveraged trades, were notably exposed. Other causes of the market panic were an interest rate rise in Japan and Yen appreciation, disappointing US labour market data, and mixed second-quarter earnings results from the biggest US tech companies.

As these market declines were driven mainly by short-term changes in investor flows rather than a material change in economic or corporate fundamentals, the sell-off was fairly short-lived. Stock prices recovered through the rest of August. By the end of the month, the S&P 500 was back near to its year-to-date high and the VIX index had dropped back to more usual levels. This episode of market panic should serve as a reminder that investing always comes with ups and downs. The most successful investors hold their nerve and stick to their strategy in the face of market storms.

Equity Markets Recovered in the Last Three Weeks of August



Sector in Focus: Consumer Staples

The MSCI World Consumer Staples Index has been the worst performing sector in the last year. While the sector posted positive returns in the past 12 months, it underperformed broader equities by as much as 15%. Consumer staple stocks typically have defensive qualities given their lower volatility of earnings and returns and greater resilience during economic recessions. Companies in this sector are typically manufacturers and distributors of everyday necessities such as food, beverages, and household and personal products. This means they have a more stable demand profile. Consumer spending has stayed resilient, notably in the US which constitutes nearly 50% of revenues for the MSCI World Index.

Currently, US labour market conditions remain broadly supportive of consumer spending, with positive real wage growth making people more inclined to spend the money in their pocket. However, there has been an increase in unemployment relative to vacancies in the US, potentially showing signs of a slowdown in US consumer spending. If this were to weaken further, it could lead to investors positioning more defensively and boost the performance of consumer staples.

To learn more about VAM Funds, please contact us at sales@vam-funds.com or on +230 465 6860.

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Source: atomos.

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