Daiwa's View

Sorting out turmoil surrounding UK financial markets

- Must closely monitor UK crisis for some time to come

Fixed Income Research Section
FICC Research Dept.

Strategist
Kengo Shiroyama
(81) 3 5555-8755
kengo.shiroyama@daiwa.co.jp

Senior FX Strategist
Kenta Tadaide
(81) 3 5555-8466
kenta.tadaide@daiwa.co.jp
Daiwa Securities Co. Ltd.

Sorting out turmoil surrounding UK financial markets

Must closely monitor UK crisis for some time to come

UK financial market turmoil, including volatility for UK government bond yields and instability for the British pound, has continued. In this report we will review the background for this turmoil up to this point and organize the future points of interest.

This turmoil began on 23 September when the British government announced a package of fiscal measures, including a proposal for massive tax cuts. While the government's response to rising energy prices, included in the fiscal measures, had already been announced, the proposed tax cuts worth 45 billion pounds caught markets by surprise. The UK government explained that the fiscal measures would be financed by increased tax revenues stemming from future economic growth. However, the UK's Office for Budget Responsibility (OBR) has not provided a forecast backing up this economic growth assumption. Furthermore, there are growing concerns about the UK government's fiscal standing along with a heightened sense of caution that tax cuts during a period of high inflation could encourage more inflation. As a result, all UK-related financial assets were heavily sold and the financial market turmoil spread to other countries. The rise in UK government bond yields was also influenced by the BOE's decision at its 22 September meeting to begin outright bond sales from 3 October.

The UK government bond yield surge during this period was reportedly due in part to the use of an investment strategy called Liability Driven Investment (LDI) by UK pension funds. LDI is a fund that makes extensive use of derivatives and is expected to manage its assets to match the future liabilities of its investors. According to the Investment Association (IA), LDI in the UK has more than tripled in size over the past decade, reaching a scale of 1.5 trillion pounds as of 2020. UK pension funds have allegedly used large amounts of UK super-long government bonds as collateral for the derivatives used in their LDI investments. Margin calls were required due to the rise for UK government bond yields triggered by the government's announcement of new fiscal measures. The selling of UK super-long bonds to obtain this needed cash spurred on even more selling, causing the yields on those bonds to rise sharply.

In order to address this turmoil, the BOE on 28 September postponed until 31 October its outright UK government bonds selling, which was scheduled to begin at the start of October. The Bank also decided to temporarily purchase super-long government bonds (remaining maturities of 20 years and longer) until 14 October. The aim of these purchases is to restore financial market liquidity. As such, there is the view that this measure is not the same as a monetary easing step. Also, there is the view that this measure will have no impact on the amount of future government bond sales. Actually, on 12 October, the BOE's chief economist Huw Pill said that liquidity and properly functioning financial markets are necessary for rate hike effects to ripple through the economy, suggesting that this is actually a measure for tightening monetary policy.

British government bond yields turned lower and the British pound rebounded following the announcement of the BOE's measures on 28 September. In response to the market turmoil, the UK government also withdrew on 3 October its plan to reduce the top income tax rate from 45% to 40%, which was part of a tax cut package. That said, the UK financial market has since remained unstable due to lingering concerns about government finances along with recognition that the BOE's bond-buying program would end on 14 October.

On 14 October, Finance Minister Kwasi Kwarteng was dismissed with his position given to former Foreign Minister Jeremy Hunt. At the same time, the government withdrew its suspension of the corporate tax hike, deciding that this tax would be raised from 19% to 25% starting in April 2023, as was reported on 13 October. New Finance Minister Hunt also indicated the possibility of tax hikes. Despite these reports, UK bond yields, which had been declining, began to rise and the British pound pulled back. The withdrawal of some planned tax cuts was supposed to allay the initial financial market concerns, but the market reaction was negative, perhaps because these missteps undermined confidence in the new British government.

The government announced the scrapping of other tax cuts on 17 October (Chart 1). Indeed, all planned tax cuts were withdrawn, except for cuts for National Insurance fees and the stamp duty land tax. Furthermore, the government's response to rising energy prices scheduled to last for two years, starting in October 2022, was revised to a measure lasting only until April 2023. The UK Treasury indicated that the withdrawal of these tax breaks and revisions to its response to rising energy prices are measures to ensure the stability of the UK economy.

Chart 1: Current Status of UK Tax Cuts

	FY					
(£ bn)	2022	2023	2024	2025	2026	
Cut National Insurance fees	-6.9	-17.0	-17.2	-17.7	-18.2	→Maintained
Cancel plan to raise dividend tax rate from Apr 2023	0	-1.4	1.0	-1.1	-0.9	→Withdrawn (17 Oct)
Cut income tax basic rate from Apr 2023	0	-5.3	-0.5	0.3	0	→Withdrawn (17 Oct)
Cut income tax top rate from Apr 2023	-2.4	0.6	-0.8	-2.2	-2.1	→Withdrawn (3 Oct)
Cut stamp duty land tax	-0.8	-1.5	-1.5	-1.6	-1.7	→Maintained
Cancel plan to raise corporate tax rate from Apr 2023	-2.3	-12.4	-16.6	-17.6	-18.7	→Withdrawn (14 Oct)
Others	-0.1	-1.7	-3.2	-4.2	-4.7	→Withdrawn (17 Oct)

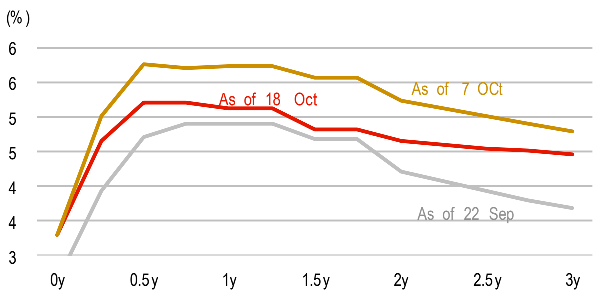
Source: HM Treasury; compiled by Daiwa Securities.
Note: Negative values indicate financial burden amounts.

The level for the policy rate's terminal rate, which the market has factored in following the withdrawal of the tax cuts, fell from around 5.5% to a 5.0-5.4% range (Chart 2). Accordingly, UK government bond yields fell sharply and the British pound rose against major currencies. However, compared to 22 September (prior to tax cut announcement), the market continues to factor in high levels for rate hikes. The BOE is probably not ready to stop hiking rates. However, considering that progress factoring in rate hikes was made after the UK government's tax cut policy was announced, the reason this factor has not dropped off is probably due in part to the poor UK bond market liquidity (Chart 3). As such, there is still room for rates to fall. That said, deteriorating bond market liquidity has been seen globally, albeit with the UK being a more prominent case, and corrections for the elevated rate hike levels factored in by the market are unlikely to occur any time soon.

We should note that a sense of stability has not yet returned to the British government. According to a YouGov survey, the approval rating for the UK government has plummeted in the wake of the developments since the 23 September tax cut announcement. There also seems to be a growing distrust of Prime Minister Liz Truss even within her Conservative Party. There is a rule within the Conservative Party that party leaders are not subject to a vote of confidence for one year after being elected. However, according to media reports, it appears that several Conservative Party House of Commons members have sent letters to the "1922 Committee" (parliamentary group that sets rules for how Conservative Party leaders are selected) to change this rule and allow for a vote of confidence. If the rule is changed and 15% of the House of Commons members belonging to the Conservative Party submit written requests to the 1922 Committee Chairman, a vote of confidence in the party leadership could take place. If a vote of confidence is not approved by a majority of these members of the House of Commons, the party leader will be removed from office.

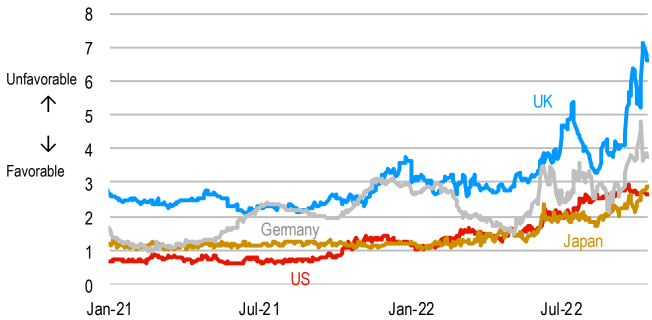
Looking ahead, we are awaiting the release of UK bond ratings from rating agencies on 21 October, the release of the government's fiscal plan and the OBR's fiscal forecast on 31 October, and the BOE meeting on 3 November. Future changes for the UK financial market will depend on the outlook for the UK economy and financial affairs. Also, the start of the postponed outright government bond sales is now set for 1 November. According to the 18 October BOE announcement, this means that the scheduled start of sales on 31 October has been postponed by one day in light of the fiscal outlook release set for 31 October. During the Oct-Dec 2022 period, there will be no sales of super-long UK government bonds with remaining maturities of 20 years and longer. The Financial Times has speculated that these sales might be postponed again, as the UK bond market has not yet fully calmed down. However, BOE Deputy Governor Jon Cunliffe believes that LDI fund vulnerabilities have improved so far and there is no indication at this juncture that the bond sales will be rescheduled again. If the BOE actually goes ahead with the bond selling, the market could again fall into a state of disorder with a full-fledged recovery for the British pound likely to take a little more time.

Chart 2: Market Pricing in Policy Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart 3: Bloomberg Liquidity Index



Source: Bloomberg; compiled by Daiwa Securities.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings

Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices

Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities

Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association