RATHBONES

SNAP ELECTION, NEW POLICIES

REVIEW OF THE WEEK
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WITH THE UK HEADING TO THE POLLS SOONER THAN EXPECTED, THE GOVERNMENT ANNOUNCES POLICIES THAT RESONATE WITH OLDER VOTERS. MEANWHILE, DISAPPOINTING INFLATION MAY HAVE KIBOSHED A SUMMER RATE CUT.

Prime Minister Rishi Sunak unexpectedly plunged the UK into election mode last week, setting Thursday 4 July as the date for electing the new Parliament.

Since then, Sunak has been touring the nation while unveiling a couple of new policies. The first was the introduction of national service and the other is unfreezing the income tax allowance for pensioners and linking it to 'triple lock' pension increases. Sunak argues that this change would prevent pensioners from paying tax on their state pension in future years. The current new state pension pays £11,502 a year, which is uncomfortably close to the frozen income tax allowance of £12,570. Today, the highest of the three yardsticks determining how much pensions rise (average wage increases, CPI and 2.5%) is wage growth at 5.7%. Most economists expect this to fall further over coming months, yet even assuming that inflation and wage growth drop below 2.5% for the next five years of the coming Parliament, the state pension would be £13,013.

This isn't actually a new policy so much as the reinstatement of an old one that was removed by the Conservative-Liberal Democrat coalition government back in the early 2010s. As the Institute for Fiscal Studies notes, in 2010-11 a pensioner's personal allowance was £9,490 up to 75 and £9,640 for those above that age. Meanwhile, a worker's allowance was just £6,475. Since then, pensioners' personal allowance is about 10% lower in real terms (i.e. adjusting for inflation), while workers' allowance is 30% higher.

Combined with the national service policy, the extra tax allowance spending amounts to £4.9bn. To fund these new policies, there would be a £1.5bn cut in post-Brexit regional aid investment funding, with the remaining £3.4bn coming from a crack-down on tax avoidance, which seems to be a magician's hat form of funding.

Sunak faces an uphill battle to defy a 20-percentage-point gap between the Conservatives and Labour in opinion polls. Meanwhile, a high number of Conservative MPs have announced they won't run for re-election, including some prominent figures such as former Prime Minister Theresa May, former Deputy Prime Minister Dominic Raab, former Chancellors Sajid Javid and Kwasi Kwarteng, former Leader of the House of Commons Andrea Leadsom and Levelling Up Minister Michael Gove. However, at 77, the number is still much lower than the 100 Labour MPs who called time ahead of the 2010 vote which ended 13 years of Labour rule.

With Labour the odds-on favourite to win the election, we outline our views on what this should mean for investors **here**.

The great British rate cut postponed

British inflation fell a long way in April, but less than expected, which has dampened forecasts of the Bank of England (BoE) cutting interest rates this summer.

Headline CPI dropped from 3.2% to 2.3%, driven lower by a big drop in the household energy price cap set by Ofgem. Economists had believed the rate would be 20 basis points lower at 2.1%, yet – **as we warned last week** – services inflation was the troublemaker. Prices for this area of the economy (including bars, restaurants, garages and other labour-intensive businesses) rose 5.9% on a year earlier. Core inflation, which removes volatile food and energy, fell just 30bps to 3.9% instead of dropping to 3.6%.

The disappointment pushed expectations for UK rate cuts further into the future. Having been broadly expected for June or August, a 25bps fall in the BoE's benchmark rate is now off the cards until September or November, according to the interest rate swaps market. However, a booming UK that inflames inflation isn't the picture created by last week's economic activity data. The UK composite PMI, (which canvasses company managers on their mood, hiring intentions and incoming orders) dropped back from 54.1 to 52.8 – weaker than expected though still consistent with the economy expanding. UK retail sales were worse than expected too, falling by 2.3% in April compared with March, but the Office for National Statistics did note that bad weather had a big impact on the figures.
Hopes of rate cuts on the other side of the Atlantic have also been dented. The first measures of US PMI business surveys were much stronger than expected. The composite PMI, which combines services, construction and manufacturing, hit its highest level in two years. US government bonds sold off in response, which meant their yields rose. This, in turn, hurt stocks slightly, albeit they

finished the week flat. US core PCE inflation for April is due for release on Friday. This is the measure preferred by the US Federal Reserve when mulling interest rate policy, so it will be closely watched. It's expected to remain flat at 2.8%. If it reaccelerates, that will spark fears that rate cuts will be on ice for much longer than most people hope.

Meanwhile, the European Central Bank is all but nailing its colours to the mast on rate cuts. In an interview with the FT, its Chief Economist, Philip Lane, said: "Barring major surprises, at this point in time there is enough in what we see to remove the top level of restriction." Investors now heavily forecast a 25bps cut to the ECB's main-refinancing rate at the next meeting on 6 June. Will this come unstuck by a 'major surprise', or will Europe be the first to cut rates?

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.

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