UK: Growth Outlook Cheers Chancellor

- **A better growth outlook is welcome news.**
- **Budget deficit in better shape than forecast.**
- **No giveaway expected now…wait for 2020.**
- **UK assets are favoured in European allocation.**

This week the UK faces its first full budget since the June 23 2016 vote to leave the European Union (EU). So, it will be a welcome piece of news for Chancellor, Philip Hammond, to hear that the Office for Budget Responsibility (OBR) is to update its growth forecasts for the UK economy from the numbers offered last November, Figure 1. That would imply a higher trajectory for actual growth as shown in Figure 2.

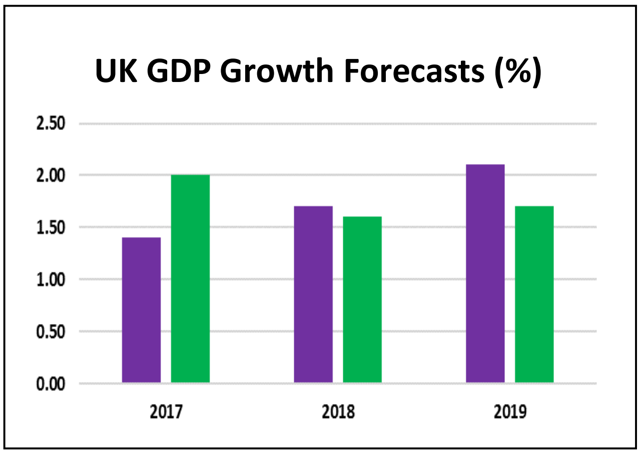

Figure 1: UK GDP Growth Forecasts (%)
Source: OBR and BOE

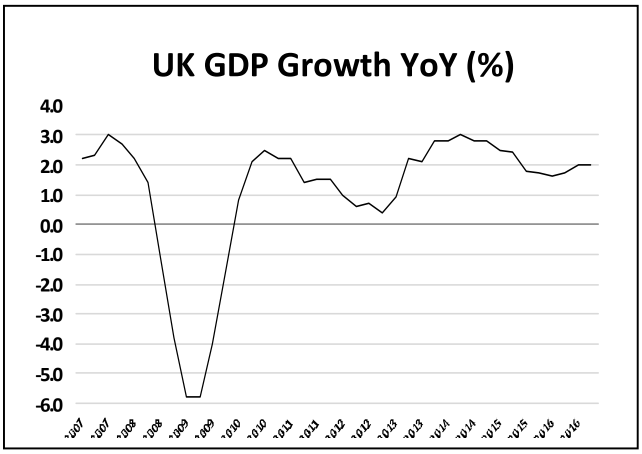

Figure 2: UK GDP Growth YoY (%)
Source: Office For National Statistics

However, Spotlight must add a note of caution. The OBR may be prepared to increase the 2017 forecast from 1.4% but it will be minded that recent signs of slower growth will suggest the upward revision will prove to be modest. Given the uncertainty that surrounds the economic path as BREXIT is enacted it would be no surprise to see projections for later years suffer a reduction.

Better tax receipts, however, no Hammond spending spree

There is optimism that the Chancellor will be able to lean on higher tax receipts of up to GBP 45 Billion over the next five years. This has come about from a rise in self-assessment tax receipts and a strong stream of capital gains tax receipts to the exchequer that has reduced the government's borrowing bill to its lowest January level since 1999.

This boost in tax receipts could allow the Chancellor to reign back on some of the expected austerity in the next financial year. The increase in tax income generated a surplus of GBP 9.4 Billion allowing the OBR to suggest the government was on track to undershoot the GBP 68 Billion deficit target at the end of the financial year.

The OBR said official figures showed the deficit had declined to GBP49.3 Billion in the financial year to date and were this trend to persist then the deficit may be running at GBP 56 Billion by March 31 2017.

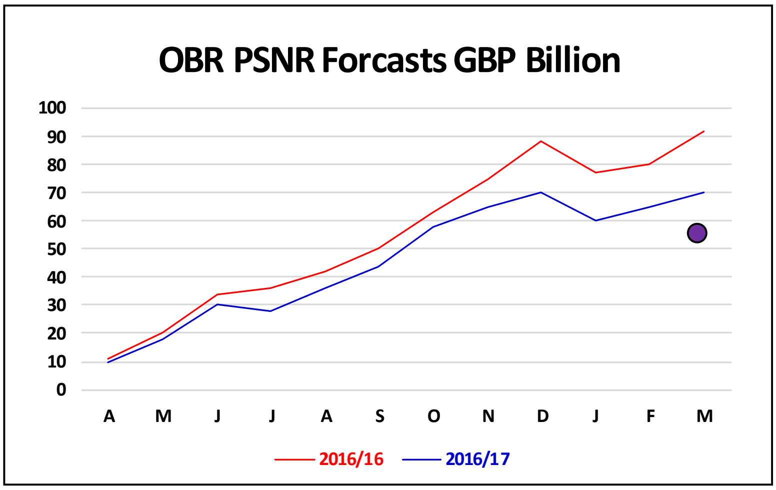

Figure 3: Public Sector Net Borrowing FY2015/16 and ● OBR Latest Forecast
Source: OBR

An improvement of some GBP 12 Billion would give a strong indication of how the borrowing levels were undershooting the previous targets, however one cannot escape the fact that tax receipts be volatile, especially as the future outlook is far from clear or certain.

Still, with the risks of BREXIT in mind one should not expect the Chancellor to use this budget as the platform for a free spending platform of budget giveaways. He is likely to want to have a cash cushion for the economy if the post BREXIT conditions prove turbulent and as all Chancellors before him...he will want room for manoeuvre in delivering pre-election sweeteners as 2020 approaches.

A test for Prime Minister May

On July 13 2016, Theresa May stood in Downing Street and proclaimed that she was looking to lead a country that worked for everyone. In that regard, the first budget that her Chancellor will give on Wednesday will most certainly be seen as a test of her credentials in making good on her aspiration.

The government faces a dilemma as they hold a commanding lead over Labour in the opinion polls and the opposition appears to be riddled in in fighting behind a rather lack lustre leader. However, opinion polls suggest that approximately 77% of the electorate want the money that is being given away as a cut in corporation tax to go, instead to the NHS. This sum is worth GBP7.5 Billion a year by 2020.

Chancellor Hammond will no doubt raise planned spending on the NHS over the remaining three years of this Parliament. However, this will be done with two targets in mind. Firstly, he will seek to swerve around any decline in real-terms spending per capita that is due to occur next year if spending remains unchanged. Secondly, he must do something constructive about social care, as the local councils across the UK are finding it an increasing strain to fully fund this service adequately. The situation is impacting the NHS by blocking beds through the delayed the discharge of elderly patients.

Spotlight is known for its pro-enterprise and low taxation bias, so naturally we support low corporation tax. That said, we are not so deluded as to be unaware or insensitive to the pressures on the NHS system. However, we would advocate a greater sense of accountability and less mantra abut blindly throwing more and more money at health provision. The NHS may be a national treasure, but it cannot expect unlimited funding.

Given that, we expect what will be announced on Wednesday will be claimed by Labour as the minimum...an amount that can kick any NHS problems into the long grass beyond 2020. Maybe Labour should look to themselves and sense that if they were more effective as an opposition then they might squeeze more NHS cash from a government that really faces no opposition.

The reason why Spotlight supports this Conservative government is that it is the only national effective party that sees the world as it really is, rather than playing politics and planning endless policies for a utopia that does not exist.

The most effective way to act for all the people is to establish the conditions where enterprises can create jobs and therefore feed rising living standards over the long-term. This is most effectively achieved by supporting business and increasing productivity by making it more competitive and by prioritising investment in skills and infrastructure.

The budget on Wednesday will set out a plan to back business and support productivity by announcing the biggest overhaul of post-16 education in 70-years to improve technical training.

The pure academic route is not for all, and yet for too long the attitude in the UK has been that young people must go to university. If they can and they gain a useful degree from a strong university that is relevant to their desired career path, then the degree itself is worthwhile. But just going for the sake of it to a third-rate institution will not serve the new graduate well at all.

It is far better to realise that for many students at school, their aptitudes are not found in pure academia, rather in practical, hands on skills. Therefore, it is encouraging that the government will unveil plans to put technical education on an equal footing with academic studies.

Teenagers who undertake the technical training, will spend 50% longer learning than they do now, equalling 900 hours of teaching a year. The programme will be funded by more than GBP 500 Million a year agreed by the Treasury once the scheme is up and running. The reforms, which will see the courses called "T-levels" so that they are seen as the technical version of A-levels, are designed to help ensure the UK economy is prepared for BREXIT and boos the nation's low level of productivity.

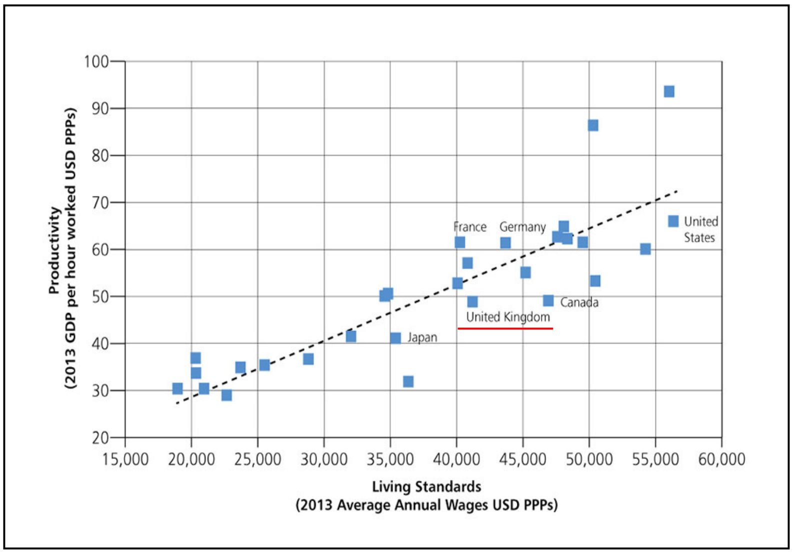

Figure 4: National Productivity and Living Standards
Source: Organisation for Economic Cooperation and Development (OECD)

This programme would be in line with the ambitions of The British Council that has suggested if the UK is to compete internationally, a productive and globally competitive workforce is vital. And that workforce will need a global outlook, cultural awareness, language proficiency, problem-solving and technical skills as well as an ability to innovate so as to be able to compete effectively on the international stage. After-all, as Figure 4 reveals the UK is well off the pace set by the US, France or Germany.

Investing in the UK...sound reasons to do so

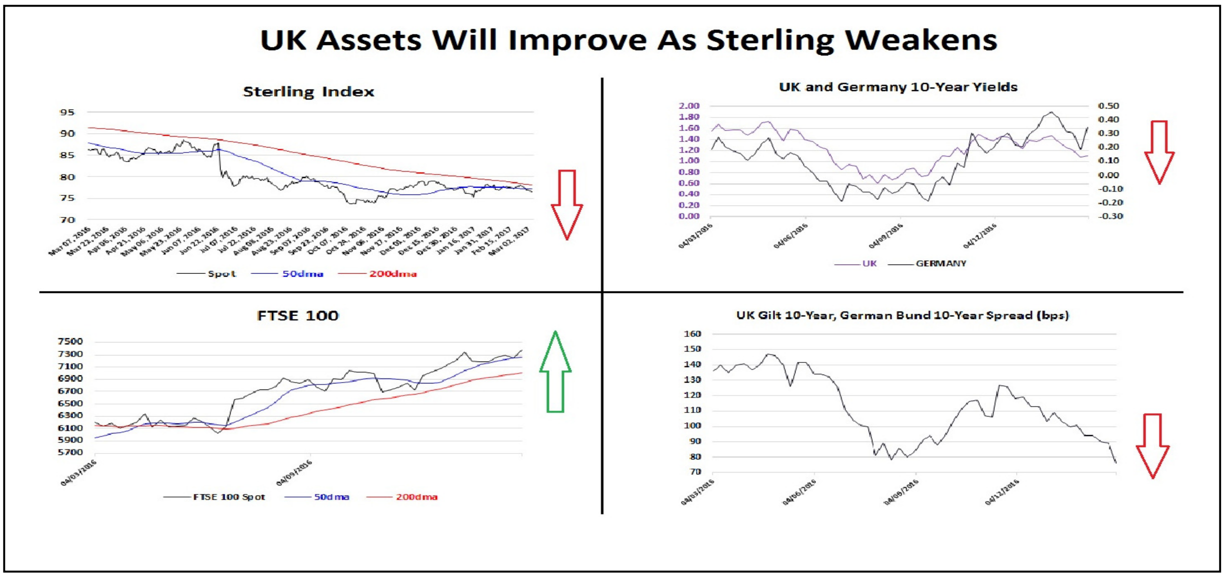

Figure 5: UK Assets (A) Sterling Index, (B) FTSE 100, (C) 10-Year Gilt and Bund Yield, (D) 10-Year Spread
Source: www.investing.com, Spotlight Ideas

The limited prospect of UK Base Rate increases this year will keep Sterling on the backfoot and that will underpin the export potential of the companies that comprise the FTSE 100 where a further 6% gain this year can be achieved.

The 10-Year Gilt spread over Germany has fallen in the past year and is now at 70 bps. With the uncertainty surrounding the German elections later in September we see Bunds coming under mild selling pressure especially if Le Pen fails to win the French Presidency.

That might imply a Macron victory in May, however, Spotlight believes this will soon see doubts increase over a spendthrift France with the Gilt market a beneficiary given the stable government and prospect of reduced deficits. This will see 10-Year Gilts yields declining to 1.03% followed by 0.97%.

In short, Spotlight is looking to overweight the UK in its European debt and equity exposure for 2017.

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