TOO CLOSE TO CALL

REVIEW OF THE WEEK
4 NOVEMBER 2024

IT'S NECK AND NECK AGAIN ON THE EVE OF THE US PRESIDENTIAL ELECTION. REPUBLICAN CANDIDATE DONALD TRUMP'S SIGNIFICANT LEAD IN BETTING-ODDS FORECASTS HAS DISAPPEARED OVER THE PAST WEEK. ACCORDING TO PREDICTIT, THERE WAS A 60% PROBABILITY OF A TRUMP WIN ON 27 OCTOBER. NOW, IT'S 49.5%.

RealClearPolling's average of national polls has Democrat Kamala Harris trailing Trump by 0.1 of a percentage point. Trump is ahead in six of the important 11 battleground swing states, but the margin of victory in some is super-slim – and the same goes for the states where Harris leads. After months of campaigning, billions of dollars and enough election reporting to doom-scroll your way to Mars, we're pretty much back where we started in the summer when President Joe Biden dropped out of the race.

While the economic policies of both sides are actually more alike than either would wish to admit – protectionist and loose with government cash – **there are stark differences that do matter for investors**. Trump's policy platform is highly inflationary and would likely exacerbate already high American federal deficits. Mostly, this is down to differences in scale, as both candidates talk tough on trade and immigration and avoid talking about yawning deficits. We will be updating you **here** with our thoughts and observations as soon as the result is known on Wednesday.

The **US government 10-year bond yield had been rising along with Trump's betting-odds chances of winning**, yet it has remained high as his lead there evaporated in recent days. It could be that investors don't believe Harris's comeback (these markets are relatively lightly traded and closely watched, which make them good targets for manipulation by those with deep pockets on both sides). Or the rise in US government borrowing costs might be driven by something other than the potential for Trump take two. The answer may become clear on Wednesday!

Meanwhile, American business continues regardless. It was an important week for company results, as some big names reported their third-quarter earnings. Technology giants Microsoft, Meta, Alphabet and Amazon all released strong sales growth and increased profit margins on their core businesses. Yet they are also spending monumental sums on the race to develop general AI. These companies revealed capital investment in datacentres and the high-performance computer chips that go in them will keep rising. In fact, Microsoft and Meta said they would increase significantly next year. The big tech companies' share prices fell back somewhat in response as investors pondered whether the investment was getting obsessive and could start gobbling up the chunky profit margins that make these businesses so feted by investors.

While this slight wobble in tech stocks sent the US S&P 500 index lower, the broad index's results were pretty solid. With almost three-quarters of companies now finished reporting, the average growth in profits for the quarter compared with a year earlier was 5.1%. That's ahead of expectations at the outset of the results season.

A classic tax-and-spend Budget

Labour's first Budget in almost 15 years and the first by a female Chancellor delivered big increases in spending, taxes and borrowing.

Chancellor Rachel Reeves hiked taxes by £40 billion (1.1% of GDP) per year, the most since 1993, with the burden falling predominantly on businesses and the wealthy. The main tax lever was increasing Employer National Insurance contributions by 1.2 percentage points to 15% and roughly halving the threshold at which they kick in. **There were plenty of other changes**, including diluting the tax-efficiency of AIM stock holdings and raising Capital Gains Tax rates.

There will also be a marked increase in government borrowing. It's forecast to rise by an average of £32bn (1% of GDP) over the next five years relative to forecasts in the March Budget. To allow this, the Chancellor made a major change to the fiscal rules. One of those rules is that the nation's debts relative to GDP must fall over the five-year parliamentary term. By using a broader measure of net public debt – all the nation's liabilities less its assets – which includes relatively more assets (like, for instance, student loans, public sector pension funds and equity stakes in private companies) than liabilities, it creates more headroom to borrow.

This represents a big loosening of fiscal policy compared to **previous (untenable) government plans to fund day-to-day public services**, although it's actually still fiscally contractionary using the benchmark measure of current budget deficits. In simple terms, that means the level of government spending will restrain economic growth slightly over the five-year Parliament, rather than boost it.

With extra spending of £70bn on average each year of the Parliament, roughly half is funded by debt and half by higher taxes. The spending also tends to be front-end loaded, with big increases this year and next, but much lower rises in following years. That's driven up the forecast for inflation slightly in the next two years or so, according to the Office for Budget Responsibility (OBR).

Around two-thirds of the new spending is allocated to day-to-day spending, with a big dollop for the NHS and state schools. The remainder will be used for capital investment, including new industry accelerator hubs, roads, railway projects, the NHS and the like. If spent well, this money should help boost long-term growth, something that the UK desperately needs. As the OBR notes in its assessment of the Budget, the benefits of this investment won't appear in this five-year Parliament. Yet, the watchdog goes on to say: "If the increased level of public investment were sustained, it would permanently raise supply in the long term and by significantly more than it does in the forecast period." The problem with long-term investments is that they are generally longer than most investors' typical frames of reference!

The UK government 10-year yield rose sharply in response to the Budget, with yields breaching 4.5% on the day of release before falling back. At the time of writing, it was trading at around 4.45%. Some of the sell-off may have been driven by concerns that borrowing will end up even larger than planned. For example, tighter spending plans later in the forecast period could struggle to stand up to political pressures.

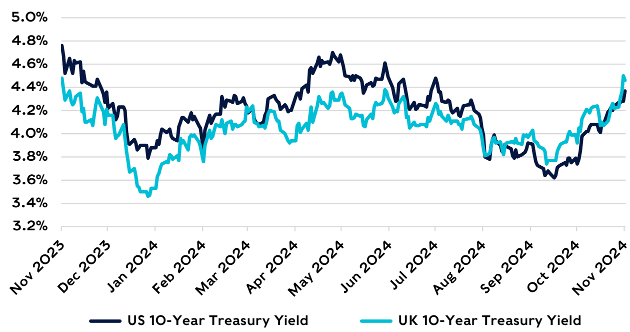
Yields can rise for three reasons, however. First, because investors expect inflation to be that much higher over the life of the bond. That reduces the real return that the bond delivers, so the price falls to ensure the fixed returns from the bond's coupon payments and eventual return of capital match what investors will accept for holding it.

Second, investors see more risks to their return over the life of the bond. This 'term premium', as it's called in the business, is slightly more nebulous than the other two drivers of bond yields. It also captures the effects of supply and demand as well (i.e. how many bonds are likely to be issued over the bond's life and how many people are likely to buy them? And same question, but for this specific bond tomorrow?). Essentially, the term premium comes down to uncertainty. More uncertainty over the path of interest rates, GDP growth, inflation and bond issuance and investor demand, and you can expect a greater term premium and a higher yield. The effect of this on bond yield movements tends to be much higher for longer-dated bonds. This makes sense, as there's much more chance of serious changes upending your investment over 30 years than over, say, five or 10 years.

And the third reason is because investors believe interest rates set by the central bank over the life of the bond will be higher once adjusted for inflation. In the short-term these respond to inflation expectations as well as where we are in the business cycle. In the longer-term, this can be influenced by factors such as demographics (which can influence the need for investment and the demand for savings) or productivity growth (higher productivity growth raises economic rates of return and in turn interest rates). Due to this last point, a really successful government growth policy would lift yields over the long-term. Although that's not what's going on in gilt markets right now. Recent market moves have been driven largely by an adjustment to expected real yields over the next couple of years.

And finally, let's not forget that UK yields take their cues from US Treasury yields (as do virtually all other nations' bonds). The US 10-year bond yield has risen over the past week as well, which could explain at least part of the rise in the UK bond yield. Despite the move in the bond market, investors still expect the Bank of England to cut its interest rate by another quarter-percentage-point to 4.75% on Thursday. They just assume that fewer cuts are likely to follow.

GILT YIELDS ARE OFTEN LED BY US TREASURIES



Source: FactSet, Rathbones; 10-year bond yields; data to 1 November

*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.*