



FLASH UPDATE



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What does the Mini-Budget mean for UK Equities?

Kwasi Kwarteng unveiled his plans to stimulate UK economic growth in the medium term and avoid a deep recession in the short term in today's 'Mini-Budget'. Whilst called a Mini Budget, the extent of the changes are likely to be seen as some of the most material ever announced in a budget. The focus is to stimulate growth to 2.5% per annum through supply side reforms and tax reductions. Whilst many of the changes had been leaked, the new measures added today, specifically on supply side reforms, will help lift growth.

The additional tax measures and energy price cap will dramatically change the profile of household free cashflow in 2023, whilst the measures on housing (stamp duty changes, new investment zones) will underpin the housing market and have a powerful multiplier effect. However, these measures will place a significant additional burden on the already stretched UK public finances.

This short paper highlights how the changes announced will impact the economic outlook, households, the market view of the UK fiscal position and certain parts of the UK stock market.

Energy Prices – a 'cap on the cap' creates certainty

Even on its own, the energy price cap will have a material effect on the UK economy. Including the £400 each household will receive, the real cap is £2,100 pa. This is before any usage response i.e. consumers using less energy, which is highly likely given the scale of the publicity on this subject. As well as reducing costs it creates certainty for households. As the Bank of England said yesterday "the (energy) guarantee is likely to limit significant further increases in CPI inflation, and reduce its volatility, whilst supporting aggregate private sector demand relative to the Committee's August projections". Kwasi Kwarteng indicated the policy would reduce peak inflation by approximately 5%. As a direct result, it is likely that inflation has or will peak in the next few months and the ominous inflation predictions of 16% and 18% from various investment banks can now be consigned to the cutting room floor. The policy will also reduce the prospect of a wage price spiral, somewhat calm industrial unrest and reduce government spending in certain areas such as index linked debt costs and welfare payments. We have already seen anecdotal evidence from company commentary that activity has stabilised into September, compared to July and August, as a direct result of this policy change.

Tax changes announced in the 'Mini Budget' – step change in household free cashflow

The well trailed reversal of the National Insurance increase and cancellation of the material rise in corporation tax were both confirmed. The former will help household free cashflow, whilst the latter is material for UK corporate earnings that are available to shareholders. All analysts have put the Sunak rise in, so there will be material upgrades to post tax profit and free cashflow to come across the Fund.

It was also announced that personal tax rates (as well as the National Insurance changes) would be cut – both the basic and additional higher tax rates. The combination of these measures coupled with the cap on energy and wage increases means a materially strengthened household free cashflow position for 2023. This is despite a rise in interest rates, which will gradually feed through to mortgage costs as 2-5 year fixes are renewed. Where interest rates peak will be an important determinant of the medium-term outlook beyond 2023.

Material changes (cuts) to stamp duty were also announced. This will take a large part of the volume of the quoted house builder sector out of stamp duty thresholds. It will also have a positive second derivative effect on other parts of the economy that correlate with housing transactions.

The roll back of regulation – 'supply side unleashed'

Truss has been very clear that she is going to champion deregulation. There have been several meetings in the last few weeks at Number 10 and 11 Downing Street involving insurance and banking executives. Broadsheet columns suggest 'a bonfire of regulation' was the narrative in those meetings. Today's Mini Budget papers state, 'later this autumn the government will bring forward an ambitious deregulation package to unleash the potential of the UK financial services sector...which will

include scrapping Solvency 2 (which is the main regulation for the insurance sector)'. Several analysts expect that the mooted changes to Solvency 2 will unlock over £100bn into UK infrastructure, energy transition and levelling up investment. This will have a material impact on the economy and will stimulate growth.

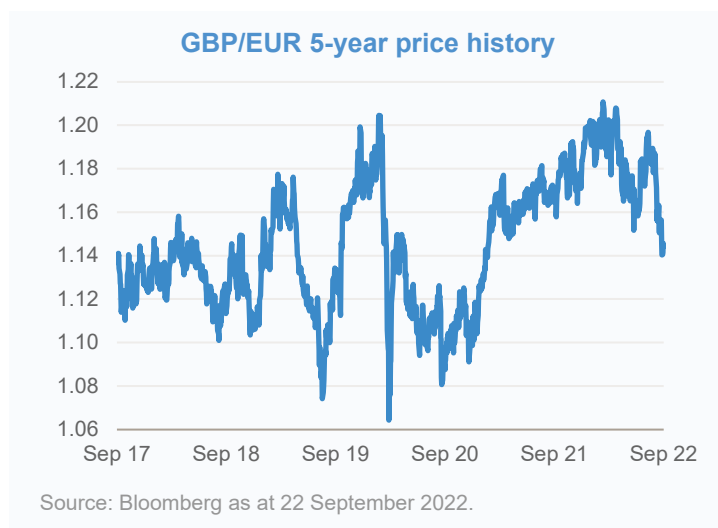
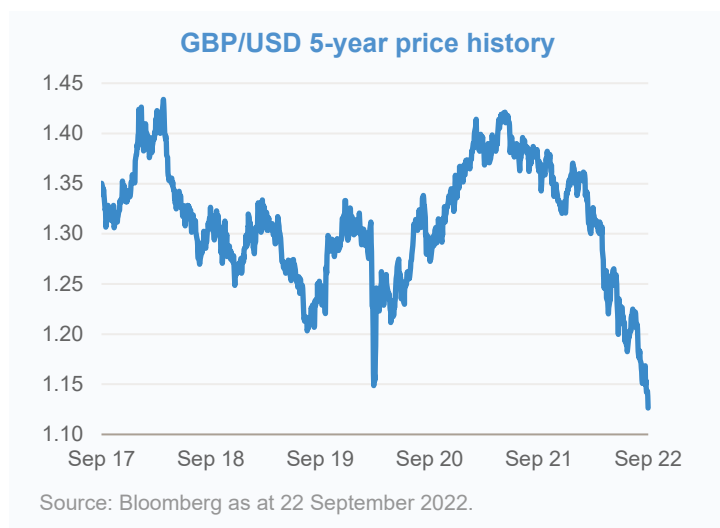
The 'mini budget' also confirmed deregulation of planning rules (which will help housebuilders and improve economic activity and measures to speed up planning for large infrastructure projects), legislation to reform trade unions / strike activity and establish new investment zones (backed by significant tax incentives). It was implied that there would be a series of further statements in the coming weeks / months regarding further deregulation.

Other measures include the publication of a list of infrastructure projects that will be accelerated. 138 projects were named, with the aim to have them started by the end of next year.

These supply side reforms and the statement of intent on the direction of travel are clear. They will likely have a material effect on economic growth over the next decade.

A crisis in Sterling? – Not at the moment

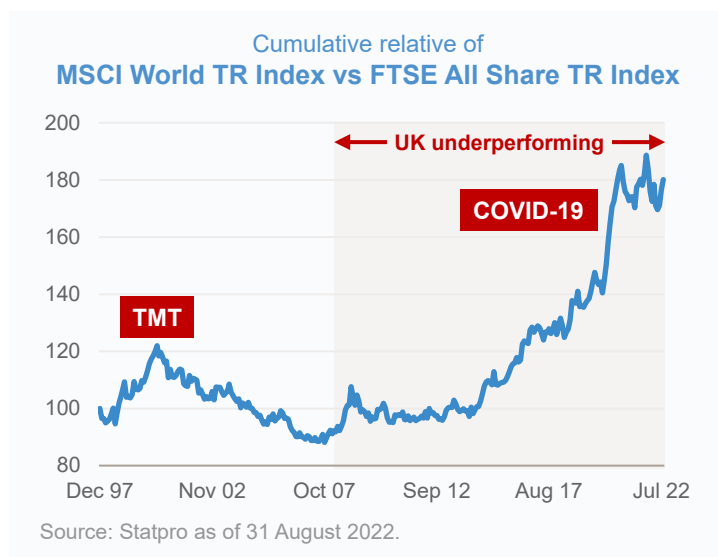
The narrative has now switched from the 'cost of living crisis', which received blanket coverage in August, to 'a crisis in Sterling' and 'a crisis in confidence in the UK economy'. The facts do not currently support this. All the commentary is focused on the GBP/USD exchange rate. This is shown in the chart on the left – we are, as widely reported, at a 37 year low. However, as the chart on the right shows GBP/EUR is down only 4-5% from its year-to-date average, is around where it was in the first half of 2021 and indeed where it has been for five years. It is a similar picture looking at the trade weighted GBP index. The story in the currency markets is **dollar strength against all major currencies, not now 'a crisis in sterling'**. We will however watch this carefully over the next few months.



It would, however, be remiss to focus on the positives highlighted above without mentioning the significantly higher borrowing that will be required to pay for this. According to estimates, the tax cuts are forecast to cost £45bn by 2027 and capping energy prices an additional £60bn over the first six months. Nevertheless, it is clear that this does, to some degree, represent a gamble by the government that the growth that could generate will offset the additional debt these measures create. As a result, we should expect some short term volatility as the bond and currency markets come to terms with this announcement.

UK Market – Years of underperformance creates the foundation for a strong recovery

The charts overleaf show that the UK has underperformed global markets for 15 years and within the UK market, value has similarly underperformed. There are clear signs the latter is reversing with the rise in real rates placing pressure on the (unsustainably) high ratings of growth stocks. In the UK market the dislocation that could happen, due to the rise in real rates has not happened yet as the 'bond proxy' defensives have continued to re-rate higher, due to general risk aversion created by global events such as Russia / Ukraine. The large 7 defensives now make up 25% of the FTSE 100. They look very exposed on valuation, given the move in real rates and could potentially fall materially, if there is any normalisation of risk appetite. The rest of the market is ultra-cheap following years of performance headwinds, and this is where the J O Hambro UK Equity Income Fund is positioned.



How is the J O Hambro UK Equity Income Fund positioned against this?

As we have outlined in recent monthly bulletins (see [LINK](#) for latest) the valuation of the Fund is around the lowest level it has ever been at, on numerous measures, versus its 18 years history.

Specifically linked to the above observations on deregulation, the fund is heavily exposed to the insurance sector (c. 10% of Fund) and the banking sector (c. 15% of Fund), with both sectors also benefiting from rising interest rates. Many stocks in these sectors could double, given their starting valuations. The Fund is also heavily exposed to the building / construction sector (c. 12% of Fund) which will profit from infrastructure spending, the stamp duty changes, Truss's deregulation and more stable household finances. Many of our construction related names have order books up over 25% year on year due to the quantum of opportunity. Elsewhere we have a range of other domestic exposures which will also benefit from the trends noted above such as ITV, Redde, retail names and transport stocks. Around half of the Fund would benefit directly or indirectly from changes announced today. A large part of the rest of the Fund is oil and mining related which have been underpinned by changes in the landscape caused by the Russia / Ukraine conflict and the green energy transition.

Both Fund Managers remain very excited about the valuation opportunity embedded in the Fund. Truss's policies could be one of the 'keys' that starts to unlock this value.

Further information

If you would like further information about the Fund, please call our Investor Relations team on +44 (0) 20 7747 8969, email us at info@johcm.co.uk or visit our website at www.johcm.com

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Please refer to the fund prospectus and to the KIID before making any final investment decisions. These documents are available in English at www.johcm.com, and available from JOHCML at the address set out above.

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The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

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