RBC Brewin Dolphin

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Markets in a Minute

In this week's Markets in a Minute video, Chief Strategist, Guy Foster and Janet Mui, Head of Market Analysis, discuss the political and economic drivers of investment markets ahead of today's momentous U.S. presidential election.

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Key highlights from markets

Markets laboured a little as October gave way to November, with some key risk events occurring last week and this week, such as last Wednesday's UK Autumn Budget and this week's U.S. election.

Meanwhile, Japan held a general election on 27 October, which saw a surprising rejection of Japan's ruling Liberal Democratic Party (LDP). It was the first time since 2009 that the LDP failed to secure a majority. That record hides the fact that Japan is typically in a state of political chaos, with a rapid turnover of prime ministers from within the LDP ranks.

Although dramatic, the market impact of a probable minority government with limited scope to make reforms was modest. The yen slid, helping stocks rise (in local currency). The market implications of the UK Autumn Budget were more meaningful.

The Big British Budget

Since coming to power, the Labour government has worked to manage expectations, discussing the need to raise taxes to arrest the deterioration in public services while also preaching the need to be fiscally responsible. Chancellor Rachel Reeves has inspired confidence in the markets due to her pedigree as a former Bank of England economist.

Against this background, the sheer size of the Budget was surprising to many. Although it perhaps reflects the very difficult position the government finds itself in, some of the numbers were really shocking. While this wasn't the highest ever tax-raising budget, it was up there.

At the same time, you couldn't really describe it as a particularly meagre Budget because despite taxes rising by £40bn, this was more than offset by increased spending, leading to a net injection into the economy of around £35bn (which will come from borrowing).

Bonds bashed by Budget

The size of the borrowing initially caused a sell-off in bonds on Wednesday afternoon, which deepened the next day. Why? Analysis of these figures leads to several conclusions. The direct impact is more government bond issuance, but the spending will lead to greater demand.

We're not quite in the stretched position we were in during 2022, when inflation was surging and then Prime Minister Liz Truss tried to stoke demand through tax cuts, but a similar problem remains.

Increasing demand through government spending at a time when there's very little spare capacity in the economy will cause inflation. To put it another way, more public sector hiring would likely mean tempting people out of private sector roles with attractive compensation packages. To combat this, the Bank of England would be obliged to offset the increase in demand through higher interest rates.

So, what does this mean for the trajectory of interest rates? It's still expected they will fall this week, but "bolt-on certainty" has been downgraded to "quite likely". Further out, interest rates were expected to fall to 3.8% over the next year before the Budget announcement; they're now anticipated to fall to 4.1%.

Generally, the interest rate trajectory had been steepening a little over the last few weeks, but a lot of that reflects falling chances of the U.S. entering a recession rather than the market anticipating an expansionary UK Budget.

The pound was weak following the Budget, which might seem odd given the prospect of higher interest rates. This belies the fact that rates are not the market's only concern.

Borrowing was higher than had been anticipated, but there are other concerns too. Although spending will be increased sharply, that pace of increase tails off in three years' time. In years four and five, it slows materially, and that's a concern. Some might be sceptical that a Labour government will slow public services investment in the two years leading up to an election.

Looming fiscal threats

The implication is that despite taxation income being expected to rise to a record of more than 38% of gross domestic product (GDP), more spending could be required later in the parliament. The political cycle suggests that at that point, it would be better to meet this through borrowing rather than taxation. This sense is bolstered by the lack of any rabbit pulled from the Budget hat.

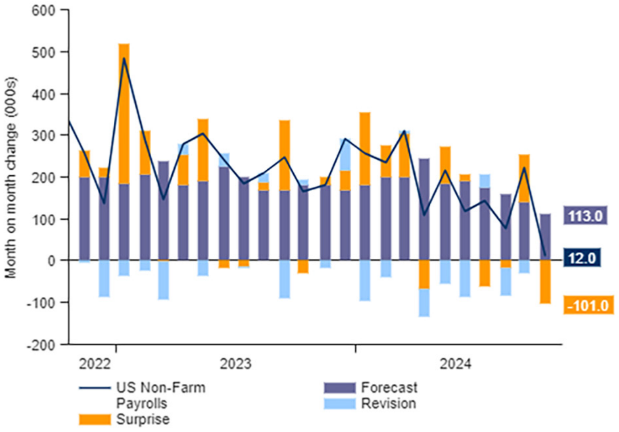
Of course, better public services should lead to higher productivity. However, despite having a well-regarded economist as chancellor, who has presumably been planning for this Budget for a long time, there was no fresh and innovative approach to tax policy, or incentives that might cause a step change in growth, which would make the new tax burden easier to shoulder.

America's mixed outlook

The third quarter earnings season reached its climax with Apple, Amazon, Alphabet, and Microsoft all reporting last week. Earnings beats have been marginally less plentiful than normal (around 75%, rather than the more common 80%). The tone has been one of resilience.

The U.S. economy has been strong over the year but was buffeted by hurricanes and a strike by Boeing staff during October. For that reason, we have a rather confusing U.S. employment report to unpick at the start of November.

Only 12,000 new jobs were added during the month, but the Bureau of Labor Statistics was unable to say how much of this was due to Hurricane Milton. More than 40,000 jobs were missing due to strike action in the transportation industry.



Source: LSEG Datastream

Although it's difficult to draw conclusions from this report due to events during October, there were reductions to the initial estimates for September and August, such that the most reliable data that can be taken from this temporarily unreliable report suggest it should be considered downbeat. This would fit with a further reduction in job openings, reported in the Job Openings and Labor Turnover Survey (JOLTS) last Tuesday. There are now just under 1.1 job openings per unemployed person.

The trend of weakness in job openings will support the Federal Reserve in cutting interest rates when it meets this week.

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