RATHBONES

Investment Update

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Burnham is Prime Minister, Healey Chancellor. What does this mean for investors?

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We look at what the two new most powerful men in Britain might do for the economy and public finances in office – and what they should do.

Andy Burnham enters 10 Downing Street having promised to “bring back hope”. His new neighbour at Number 11, Chancellor of the Exchequer John Healey, might not be feeling quite as optimistic, given the challenges he faces as the next steward of the UK’s public finances.

Government debt is high by historical standards – gross government debt is around 100% of the UK’s annual output. Borrowing costs have risen significantly in recent years and are above those for most other advanced economies. Taxes are on track to reach record levels, relative to the size of the economy. Public services and infrastructure are creaking. Meanwhile, new spending pressures are emerging as the UK tries to navigate a more volatile geopolitical environment and support an ageing population. For more on what ageing populations mean for economies and investments, please see our special report and slideshow.

Quick take:

- Healey brings deep experience to his new role as Chancellor – and a probable desire to spend more on the armed forces.
- Burnham has sent gilt yields up by calling for fiscal “flexibility”.
- We offer the new Chancellor five recommendations for growing the economy.

Market reaction

Since becoming heir presumptive to Keir Starmer, Burnham had managed to avoid the sort of negative market reaction that might have once seemed likely, given how sensitive gilt yields became to reports about his manoeuvres last year to replace Keir Starmer. Indeed, his repeated public commitments to fiscal prudence appear to be a tacit acknowledgement of the need to rebuild credibility with investors after his infamous 2025 comment about getting beyond being “in hock to the bond market”.

However, Burnham’s first comments as Prime Minister have hit a raw nerve with investors. The problem lay in just a single word he used, when talking about the self-imposed fiscal rules that limit how much of a deficit the government can run: "flexibility".

As unthreatening as that sounds, it opens up the possibility that he's contemplating stretching the UK's fiscal rules to their limit. He might stick to the letter of the law, as it were, but not necessarily the spirit. And investors remain on edge, owing to past shocks. Once that cat was out of the bag, no further insistence on a "very prudent approach" was sufficient to stuff it back in again.

This is something of a disappointment. Burnham's earlier comments had been more guarded, prompting investors to declare a truce. This had generated some relief, with bond yields falling from their recent peaks at the time of Labour's drubbing in the May local and mayoral elections. Yields had, admittedly, started to rise again more recently. But this had nothing to do with UK politics – it was a response to the renewed hostilities in the Middle East, which had pushed up oil prices. We'd also seen a more durable and steady rise in the value of the pound.

Both are sensitive barometers of political sentiment in financial markets.

Burnham's first afternoon as premier saw the 10-year gilt yield rise by 8 basis points (bp) – hundredths of a percentage point – to 5.03%. That might not sound large, but it's quite a big one-day rise for government bonds. That was in contrast to broader increases of 1 or 2bps in European markets on the day. The 30-year yield rose by 9bps to 5.74%. This is not far short of the recent peak of 5.84%, which was the highest level since 1998. Looked at another way, this means that every £1bn that the government borrows on a ten-year term leaves it liable to pay around £50m a year in interest. That has to come from somewhere – most probably higher taxes.

What exactly might this "flexibility" result in? Bloomberg reported the views of the influential centre-left Resolution Foundation. It believes that, for example, the government could widen the remit of certain public financial institutions, such as the National Wealth Fund. Money injected into this fund, which would, in turn, attract further private sector investment, wouldn't count towards the official fiscal deficit numbers.

Even so, the associated interest payments on the debt would count.

Some argue that this matters to bond investors, who have fired their first warning shot.

Others argue that bond investors care more about broad fiscal sustainability than how things are scored relative to the rules, which are at best an approximation of what might be required to deliver sustainability.

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Taking stock(s)

When it comes to the UK stock market, higher yields (and the threat of higher taxes) weighed on traditionally rate-sensitive sectors, including utilities, housebuilders, real estate companies and domestic retailers. The wider market was more in line with global markets on the day.

The pound was, in fact, relatively unmoved. It was slightly weaker against the dollar but firmer against the euro. And if you think our politics are messy, just wait until next year's French Presidential elections, now that National Rally's Marine Le Pen has been cleared to run. The first polls since the news suggest that this far-right politician, who would probably widen the deficit if in power, would win a run-off against all the other potential candidates.

Views on Healey

Back to the British situation, the announcement of a new Chancellor was supposed to be the day's biggest news. But it arrived after markets had closed in the UK. It certainly came as a surprise. From an investor's perspective, in a recent Bloomberg Markets Pulse Survey of Bloomberg subscribers – broadly speaking, financial market participants – he placed second after Wes Streeting as the preferred Chancellor, ahead of both the early front-runner Ed Miliband and the recent front-runner Shabana Mahmood. So this should be a positive (or at least not negative) development.

Tuesday morning's market reaction to the appointment was limited and perhaps clouded by the release of public finance data. On this front, at least, Healey received a small boost as the monthly deficit was smaller than expected in June. Moreover, there were downward revisions to previous months' data. Indeed, the £16.0bn figure for June versus the consensus expectation of £17.8bn more than covered the new Chancellor's first act of generosity: to abolish the 5% VAT rate on energy bills, at a cost of around £1bn per annum. Furthermore, there was nothing in the May employment data to suggest that the Bank of England will have to adjust monetary policy in the near future.

Gilts rallied marginally on Tuesday morning, slightly outperforming other regions. The pound was little changed, remaining at the upper end of its post-Brexit trading range and at 12-month highs against the euro. To some degree, this reflects higher UK interest rates, but it suggests relative calm amongst the global investment community.

Challenged Chancellor

Healey's experience at the Treasury will be a start; he served as a minister there from 2002 to 2007 during the Blair administration. However, it's notable that Healey resigned just last month as

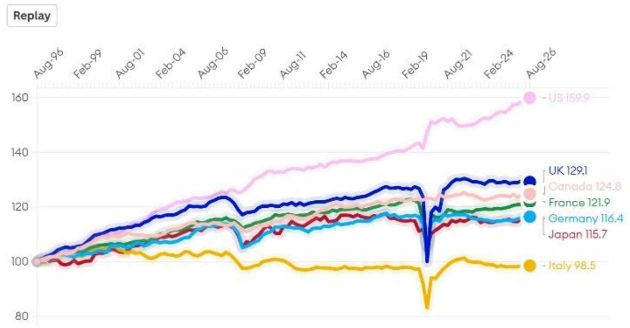
Defence Secretary after the Treasury refused to fund the defence investment he thought necessary. That suggests that in his new role, he may try to find money for the armed forces through tax rises, spending cuts elsewhere, or more borrowing. In the long run, though, by far the best way to fund higher defence spending and set the public finances on a more sustainable path is to focus on delivering stronger economic growth.

After all, weak economic growth is part of the reason the UK is in this fiscal bind to begin with. Slow growth since the 2007-9 Global Financial Crisis has led to sluggish increases in tax revenues. In response, governments increased tax rates and constrained investment spending to stay within fiscal rules. But these decisions arguably hampered growth even further, leading to a vicious cycle. Ultimately, a larger economy is the silver bullet that would allow the government to spend more and reduce the debt burden, without having to hike taxes.

With this in mind, it's worth revisiting the five recommendations we made ahead of last year's Budget that we believe would help drive economic growth. As we said at the time, this is not a complete agenda, and some trade-offs can only be made by democratically elected governments. However, we think that taken together, our recommendations would help set the new Chancellor on the road to success. [You can access the full report on this webpage.]

Power of an hour

In the late 90s, UK outpaced US productivity growth – before the US raced ahead. But other G7 countries have done worse. The right investment would boost productivity.



Source: OECD, Rathbones. Numbers show each country's cumulative growth in output per hour, starting in 1996. For example, UK growth has been 29%.

Message to Healey: our five recommendations for growth

So, what do we think Healey should do as Chancellor?

Use pensions to support productive investment

First, Healey should ensure that the pension system supports investment in productive assets. This means building on recent measures that try to ensure pension funds are better placed to provide the outside financing that smaller UK firms need to invest. It also means steering clear of tax changes that disincentivise pension saving. Our estimates suggest that capping higher and additional tax reliefs at 25% could remove at least £50bn worth of savings that would otherwise help fund the investment the UK economy so badly needs.

Reform business taxes

Second, the new Chancellor should pursue reforms to business taxes, such as business rates and capital allowances, that encourage investment and entrepreneurship. Burnham has recently floated cutting business rates for high street businesses, funded by higher levies on the likes of warehouses. But we think that misses the wood for the trees. Energy would be better directed towards broader reforms to the system that addressed current disincentives for firms of any type to invest in their premises. On capital allowances, we think Healey should build on the 2023 decision to allow full expensing of certain plant and machinery investment. He could do this by making incentives for other types of investment more generous too.

Make public investment in the right places

Third, public investment should be directed to the regions and sectors where it will have the biggest benefit. There are big regional inequalities when it comes to transport spending, for example, even though many northern cities are well-placed to benefit from agglomeration effects (where working populations become more productive when they're clustered together in well-connected regions). And if done correctly, devolution could help by ensuring decisions are made by those with local knowledge, and that local authorities are incentivised to deliver growth too. Burnham has made devolution and regional investment central to his pitch, so we expect the new Chancellor will be on board with this as well.

Don't create a wealth tax

Fourth, Healey should resist calls from those pressuring him to impose wealth taxes. Burnham has recently suggested that such measures are not on the agenda immediately, while also refusing to rule anything out. But we think ruling wealth tax proposals out would be wise. They're expensive to administer, have unintended consequences for holders of illiquid assets, and can create substantial distortions that discourage the sort of productive investment the UK so desperately needs. We think a 2% tax on assets, for example, would lead to at least £100bn leaving the UK or moving into less productive assets.

Reform property taxes

Fifth, damaging property taxes should be reformed. Economists from across the political spectrum agree that stamp duty land tax is economically damaging because it penalises transactions, gumming up the UK's housing market. Disincentivising moving makes it harder for people to find jobs they are better suited to – they can't move to where they are. That makes it more difficult for firms to find the right staff. It also means disincentivising the 50% of owneroccupiers with two or more spare bedrooms from downsizing and freeing up space for growing families. That would help the country use its housing stock more efficiently. Burnham is a longstanding advocate of scrapping stamp duty in favour of an annual land value tax – a tax based solely on the value of the land a property sits on. This would be practically and politically tricky and the devil would be in the detail. But in theory, that sort of reform would help boost growth in the long term.

The barriers are still up

Labour won the 2024 general election promising to “kickstart” economic growth. But our assessment is that most of the key structural barriers to doing so remain unaddressed, two years on. Healey would be wise to make that pledge his core focus if he truly wants to deliver the sustainable public finances Burnham says his new government will be committed to.

Additional information

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