New Monarch, New Government, New Era: Where Does the UK Go from Here?

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It is a new chapter in the United Kingdom. In short order, the nation has seen a new monarch, with the accession of King Charles III, and a new Government, with Liz Truss as the incoming Prime Minister. England has even won a major football championship, the Women's Euros, for the first time since 1966. In many ways, the country feels as if it has turned a new page, and it seems to be doing so determined to make a break with the past. This new page is not without its challenges, though.

On September 23, the new UK Government released the first major item on its to-do list. The Growth Plan 2022 set out a plan to reinvigorate the UK economy in the face of pan-European headwinds (high energy prices, elevated inflation, rising interest rates) while seeking a break from the previous generation of orthodox thinking.

Rather like an incoming football manager deciding that continuing the dour defensive football of recent managers will not win any silverware, nor please the fans, Truss and her Chancellor of the Exchequer, Kwasi Kwarteng, opted for a more proactive, attacking approach. Confirming the priority for the Bank of England to remain independent and in charge of monetary policy (in this analogy, retaining the solid goalkeeper and defense from the previous manager), the Growth Plan focused on a package of fiscal policies to boost growth (in the same analogy, buying some new forwards and midfielders and giving them the freedom to push forward and score more goals).

In doing so, the new UK Government sided with the view held by economic critics of recent orthodoxy, who argued that drastically cutting discretionary spending and raising taxes in the name of austerity served as a brake on growth and productivity, and led to sub-optimal economic performance. Truss considers the role of the government to be to incentivise and support economic growth, leading to higher productivity, higher tax receipts, higher returns, and a more satisfied population. In turn, the Bank of England acts as a complement, adjusting monetary policy to regulate growth, rather than being the panacea to all ills, to which government policy should be subordinated. Seen another way, if the UK economy is a car, the new Government's view is that it is in charge of navigation and steering, while the Bank of England is in charge of the throttle and brake. In contrast, the market seems to expect government fiscal policy to work hand-in-glove with central bank monetary policy.

UK Growth Plan 2022

So, what measures were actually in the Growth Plan?

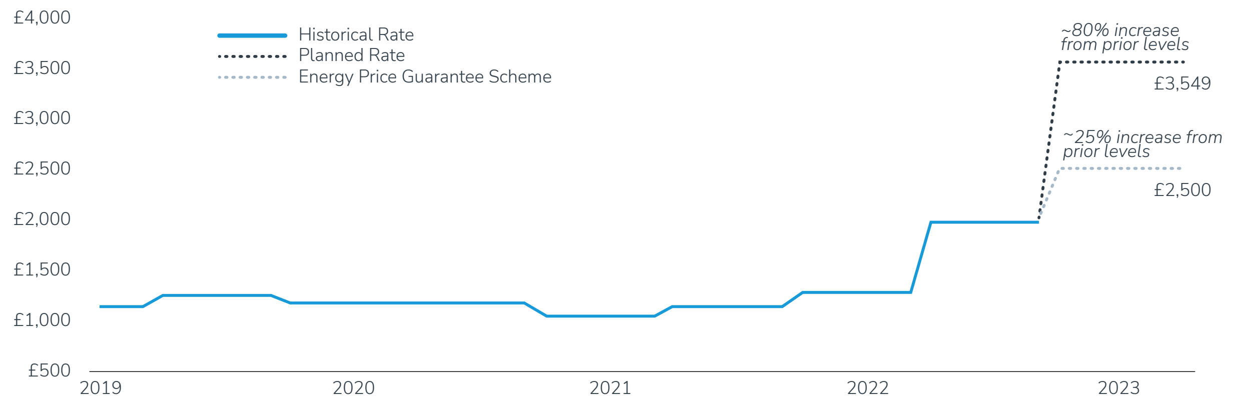
Category	Policy	Impact
Taxes	Cancellation of planned corporate tax increase from 19% to 25%	Increases return on investment, making UK investment more attractive
	Reduction of national insurance contribution rates by 1.25%	Lowers cost of employment for businesses
	Increases the Annual Investment Allowance to £1MM	Encourages business investment in productivity-increasing technology and machinery
	Reduction of basic rate of personal income tax bracket from 20% to 19%	Reduces tax burden on all tax-paying citizens
	Elimination of the top rate (45%) of personal income tax	Policy cancelled on October 3
Energy	Implementation of Energy Price Guarantee (EPG)	Limits the rate (£/kWh) energy companies can charge customers, saving the average household £1,400 per year and reducing energy inflation
	Implementation of Energy Bill Support Scheme (EBSS)	Provides £400 per household for energy bill relief during winter months
	Implementation of Energy Bill Relief Scheme (EBRS)	Limits the rate (£/kWh) energy companies can charge customers, reducing producer cost and reducing core inflation
	New oil & gas licensing round by North Sea Transit Authority	Makes more land available for production, with the intent of increasing supply and reducing energy prices
	Elimination of fracking ban	Makes fracking legal within the UK, with the intent of increasing supply of oil & gas and reducing energy prices
Boosting Growth & Productivity	Creation of "investment zones" throughout the country	Incentivizes investment and job creation throughout the country
	Creation of £500MM fund for STEM research & start-up funding	Incentivizes research and innovation in highly skilled, durable fields
	Reforming pension fee caps	Makes additional pension capital available for investments in areas such as STEM research and infrastructure
	Reduction of national insurance benefits	Encourages labour force participation
	Tightening employment incentives for part-time workers	Encourages labour force participation
	Reforming immigration policy	Attracts and retains highly skilled labour to help with the labour supply imbalance

Indicates cancellation

In addition, further updates were flagged in the near term on key areas which can boost growth, including planning and digital infrastructure.

What a relief: capping household energy costs

Average annual household energy cost before and after Energy Price Guarantee, £



Source: Gov.uk

Market Reaction

The theory behind the Growth Plan is consistent, but it is at odds with recent orthodoxy, which largely holds that controlling inflation, interest rates and monetary policy is the priority, and that fiscal policy should operate to that same end, rather than fiscal and monetary policies being complementary. This orthodoxy stretches across the political, economic and media spectrum - breaking from it would not be easy, and so it has proved.

Truss and Kwarteng have a point in arguing that these policies may be what the UK requires in this post-Covid and post-Brexit landscape to attract investment and make the country more competitive internationally. However, this medicine would taste bitter, so presentation and execution would be key to selling the policies domestically while reassuring the financial markets. It is in this execution and the politics of the announcement, where Truss and Kwarteng have appeared somewhat naïve. Communication was poor and too much emphasis was placed on tax cuts, particularly the unexpected and eye-catching announcement of the elimination of the top (45%) rate of income tax, and less on the growth-focused policies. In addition, the standard Office

for Budget Responsibility (OBR) independent forecast that typically accompanies budgets and such fiscal policy announcements was absent, leading markets to question how the budget would be balanced. This meant that the perception was largely one of tax cuts and unbudgeted giveaways to high income taxpayers, even if most of the tax changes were the cancellation of upcoming or just-activated tax increases (for companies) or bringing forward the already-announced cut in the basic rate of income tax from 20% to 19%. This was not helped by the Chancellor's suggestion in his statement of more tax cuts to come in coming months.

What this meant in practice is that the Growth Plan 2022 was poorly received by domestic critics, who were focused very much on the tax changes, and by the financial markets at a difficult moment when persistent inflation and recent interest rate rises were being digested. Apart from the elimination of the 45% higher rate of income tax, the key policy announcements had largely been flagged in advance, with UK government bond yields and swap rates increasing but in an orderly fashion. After the Growth Plan announcement though, UK government bond yields and swap rates increased sharply. The markets appear to have reacted to the poor presentation and communication, and the likely direction of future policies, more than to the principal Growth Plan measures.

In the days since the Growth Plan was announced, the bond markets and swap rates have been volatile, while the Pound touched new lows against the US Dollar before recovering to pre-announcement levels. This has led to areas of stress from second order effects. The Bank of England intervened with a targeted gilt buying programme on long-dated (>20 year) UK government bonds to restore market stability; while the Bank of England announced this to be a £65B programme, they ultimately only bought less than £4B of gilts. This intervention has since led to some settling across bond markets and swap rates although S&P and Fitch have placed the UK on a 'negative' outlook. In addition, on October 3 the UK government backtracked on the eye-catching headline of the elimination of the 45% higher rate of income tax, understanding that the focus on this announcement overshadowed the rest of the Growth Plan, but underlining the political naivety of its inclusion in the first place.

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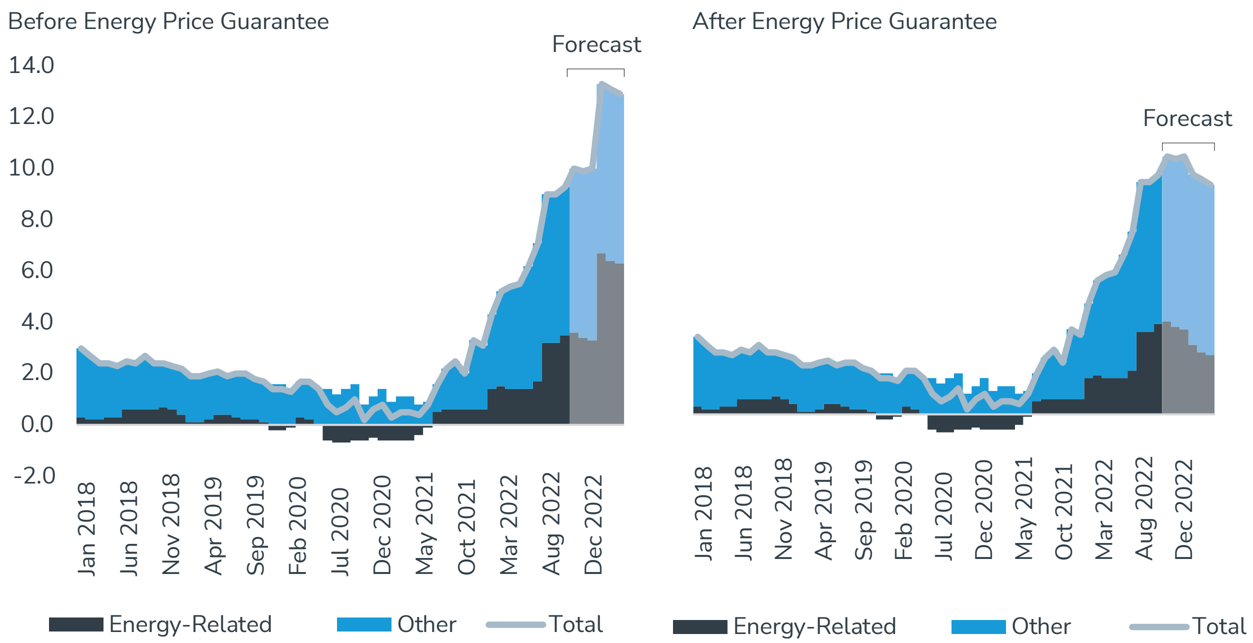
Rising to the inflation challenge
Actual and forecasted inflation in the UK



Source: Bank of England

Net Zero

Not a part of the Growth Plan but previously announced, the Government has commissioned a review of its net zero strategy. The UK Government has legally bound itself to become net zero by 2050 and Liz Truss signed up to the net zero commitment as part of her campaign to become Conservative Party leader, so we do not expect any relaxation of regulations or measures to reach these targets.

The interesting angle is that the appointed chair of this review is the MP Chris Skidmore, arguably the leading proponent of net zero within the Conservative Party but also an advocate of using a pro-growth approach to achieve this, rather than a tax-led brake on innovation or technological advances. Seen through the lens of the Growth Plan, one can see the consistency of approach and we expect to see attractive investment opportunities coming through in the fields of sustainable investment, energy efficiency, renewables, and environmental upgrades to existing buildings and infrastructure to comply with tightening energy efficiency criteria.

Investor Positioning

What does this all mean for the UK economy and investor positioning? There has been quite a lot of media doom-mongering over the market reaction, replete with comparisons to emerging markets; however, some of the reaction may have been exaggerated. Within two weeks of the Growth Plan announcement, the Pound has recovered its losses and is trading higher, 10-year Government yields are almost at prior levels, and swap rates are easing. Instead, we consider this an attractive cyclical investment period.

It appears that the announced Growth Plan initiatives, coupled with likely announcements in upcoming updates, should benefit a wide range of companies and sectors. All companies should benefit from lower taxes (not just corporate tax but also National Insurance and Annual Investment Allowances) and capped energy costs, and small and medium enterprises (SMEs) and start-ups will also be supported by the extension of investment schemes that provide tax benefits to their investors. These measures should give a boost to VC and early-stage investors, alongside an announced £500m scheme to back UK science start-ups. On the negative side, financing costs will likely remain elevated for longer, putting restrictions on near term growth. Companies reliant on consumer discretionary spending will likely struggle in the near term but those providing essential goods or business services should remain resilient. Firms that are already tech-enabled or increasingly automating also appear favourably positioned over the medium term. Of course, not all companies will capitalise to the same extent.

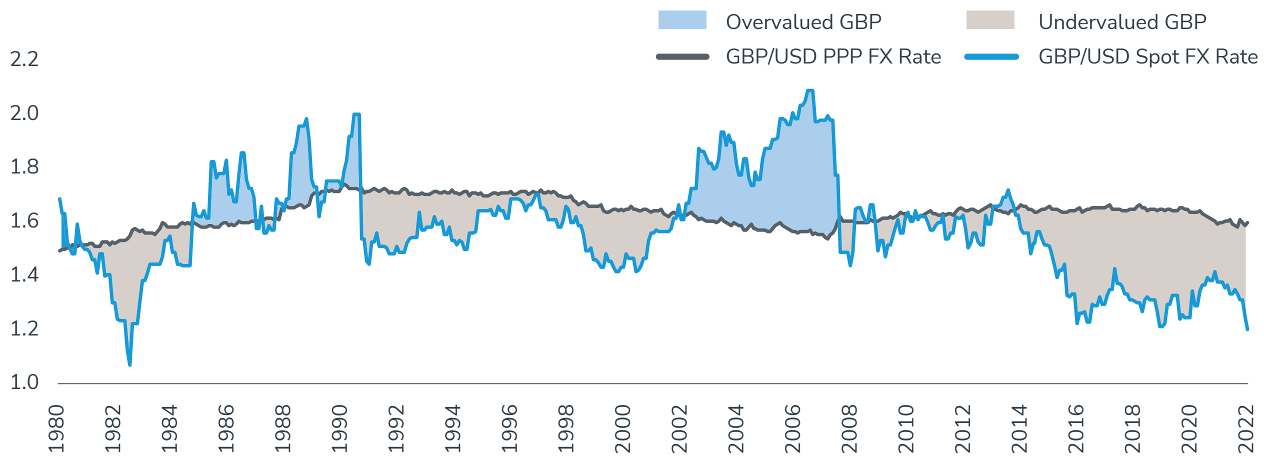
200m sq ft
UK logistics occupier requirements logged with Savills in H1 2022

Real estate and infrastructure should also be favoured. With capitalization rates rising in response to rising interest rates and the Pound at a generational cyclical low against the US Dollar, the conditions are primed for one of the most attractive investment windows for US Dollar-denominated investors since 2009, especially for occupationally resilient sectors such as industrial or student housing, where shorter term leases can more easily provide an inflation hedge. The announced investment zones, with the intention of naming many of these by end 2022, have the potential to create additional hotspots for economic activity with significant tax breaks, while streamlining approval processes for infrastructure projects should support investment in key areas across the country.

There are 138 infrastructure projects already earmarked for Government support. These include:

- 86 road projects
- 10 railway projects (including the landmark Northern Powerhouse Rail scheme to link Liverpool, Manchester, Leeds, Sheffield, and Hull)
- 16 local transport projects, including a new mass transit system in West Yorkshire
- Electric vehicle and decarbonisation projects
- Five hydrogen pipeline and storage projects
- Two carbon capture and storage projects
- Two new nuclear power plants
- Seven offshore wind projects
- Five oil and gas field projects

In for a penny, in for a pound
Spot and real exchange rates (PPP), GBP/USD



Source: S&P, Federal Reserve, Bank of England

In terms of timing, it is impossible to predict the bottom of this economic cycle. Investors would be better served by a programmatic approach that invests through the cycle, targeting resilient assets in a disciplined, focused strategy.

In the financial sector, we await with interest forthcoming announcements on regulatory reform. With the global importance of the City of London, significant reforms have the ability to materially 'move the needle' and unlock further growth and investment opportunities, although given the reaction to the Growth Plan and the political considerations involved, these may be brought forward more slowly than originally planned.

This is the first step, and a difficult one at that, but it seems clear that the United Kingdom is embarking upon a new journey, one with burgeoning potential (and some pot holes) for investors, both domestic and international. Now it is a question of whether England's men's football team will have a new manager in time for the Qatar World Cup. That really would complete the full sweep of a new establishment.

It's Not All About London

London, and the City of London in particular, may often claim the headlines but UK Government policy is firmly set on the rest of the UK, including Scotland, Wales, and Northern Ireland. The regional UK economies house many major sector clusters, and not just in visible areas such as financial services or automotive. For example, Bristol and Bath house a significant tech and digital media ecosystem, Oxfordshire is a key scientific and aerospace centre, and Hull is a leader in renewable energy.

To drive this regional growth further, 'levelling up', or spreading the benefits and opportunities of economic growth around the country, has been the mantra for some time and the Growth Plan initiatives are designed to push this strategy forward.

Headlines include a £500m fund to invest in science start-ups, targeting not just world class life sciences hubs in Cambridge and Oxford but major, less well known, centres such as Glasgow and Manchester. Infrastructure projects to be accelerated include offshore wind, carbon capture and storage, hydrogen, decarbonisation schemes, and nuclear power plants. Investment zone discussions are already underway with 38 local authorities from across England, with Scotland, Wales, and Northern Ireland to follow.

More broadly though, tax cuts, energy price caps, and supply side reforms are aimed at supporting and energising the SMEs that provide the economic backbone of the UK, that account for over 60% of private sector employment, and that are the rock upon which regional UK economies are built. We expect these measures to be effective in driving SME growth over the medium term as well as the various regional sector clusters, opening up attractive investment opportunities throughout the UK.

A wind turbine blade factory in Hull is planned to double in size after the government confirmed financial support.

Looking Ahead to 2025

Under the United Kingdom's political framework, voters select a party rather than a leader, and a general election to do so takes place at most every 5 years. The Conservative Party won a majority at the 2019 general election, and Liz Truss became Prime Minister by winning the election as the new leader of the Conservative Party.

What this means is that Truss has until January 2025 at the latest to implement her policies and see the fruits of their success before a general election needs to be held. This is not a long time, which helps to explain the impetus to design a high impact package of measures and launch them immediately, but also the political impact of the critical and market reactions to the Growth Plan.

Truss knows that in the next general election voters will judge her and her Government based on a) navigating the current cost of living impact from energy prices and inflation, b) delivering economic growth and c) stewardship of the National Health Service, so these are the initiatives that will be heavily backed. In recent years many have played down and underestimated Liz Truss, but she has proven doggedly determined and thick skinned. While it is a challenging time, a 71 seat working majority in the House of Commons and no clear internal opponents, means she needs to be in a powerful position to deliver with a clear eye on her objectives. The Conservative Party should typically be united behind her and focused on electoral success in 2025, especially with party rules not allowing a no confidence vote before June 2023, although the strength of this internal support will likely depend on her response to the current criticism.

The reaction to the Growth Plan makes this a challenging time for Truss. Many critics expect swift backtracks or recommitment to recent orthodoxy, and the backtrack on the elimination of the highest rate of income tax has seemingly reinforced their opposition, but her determination and thick skin, plus the challenging road she already faced to get here, suggests that Truss will look to stay the course and trust her policies. Whether the Conservative Party makes that easy may be another matter.

Is It 'Coming Home'?

At a time of unusual change comes an unusual World Cup. Qatar 2022 will be held in November and December rather than the traditional summer slot, and so provides a different set of challenges and opportunities.

Premier League players generally contend with fatigue and burnout towards the end of a season in a league that is more physically taxing than those in Spain, Italy, or Germany. Only last season Liverpool got close to an unprecedented 'quadruple' (of English league title, Champions League, FA Cup and League Cup) only to fail to win the league title on the final day and lose the Champions League final; their players exhausted after having played every single match they could have that season. This time through, the World Cup arrives in November when Premier League players are at peak fitness. Will this help England? Presumably, but then again many other countries will have the same advantage. Will key players be in form then, or risk injury before the tournament starts?

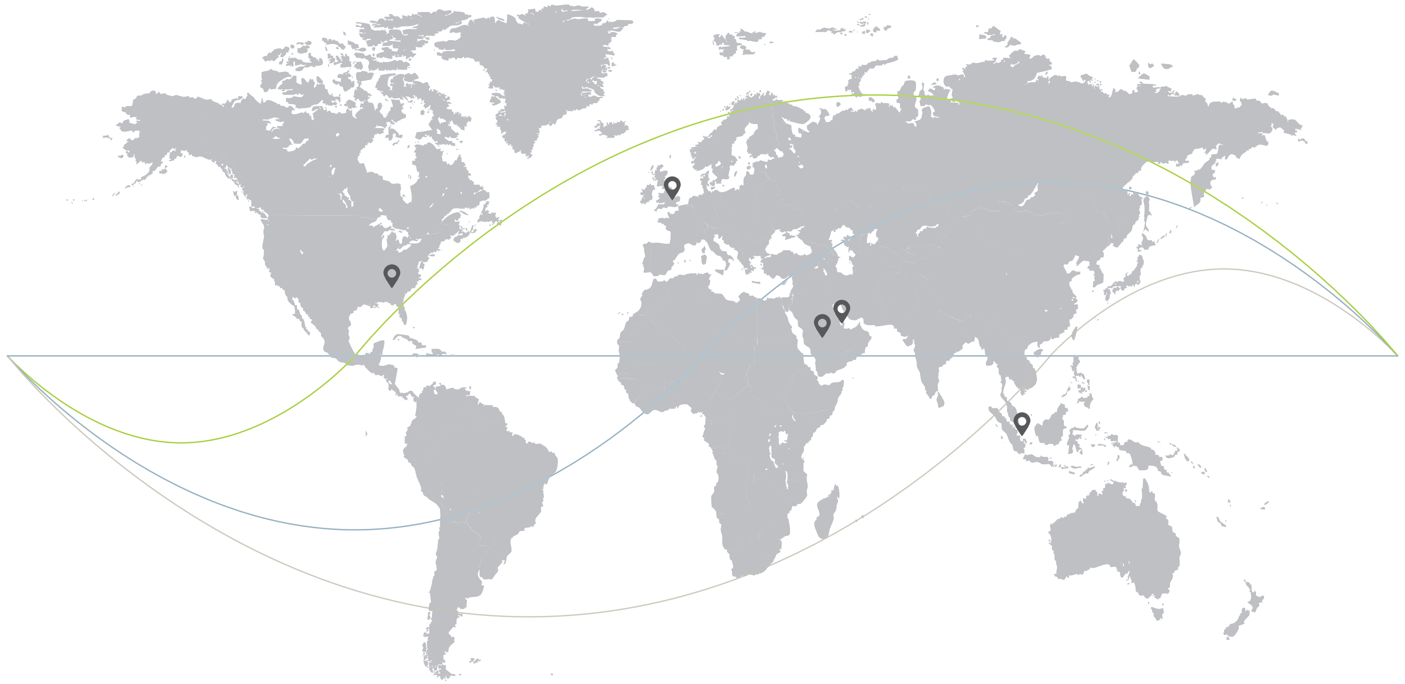
Either way, England has curiously low expectations considering they were semi-finalists in Russia 2018 and runners up to Italy in last year's Euros, and in light of the sky-high expectations that usually accompany England to football finals. Recent Nations League underperformance (especially a 4-0 humbling by Hungary at home in June) has led to widespread grumbling about the tactics of manager Gareth Southgate and tempered fans' belief. Has this England team already peaked? Or are low expectations and a November slot exactly what the team needs to deliver their full potential? We do not have long to wait to find out – and a group including Wales, the United States and Iran seems tailor made to test England and discover the truth. We can't wait.

ARCAPITA

Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, and Singapore. Arcapita's management team has completed over 90 transactions with a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



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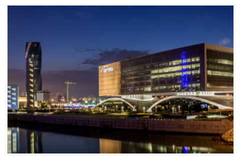

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