

Hymans Robertson Investment Services (HRIS)

Autumn Budget 2026: New Chancellor, same challenges

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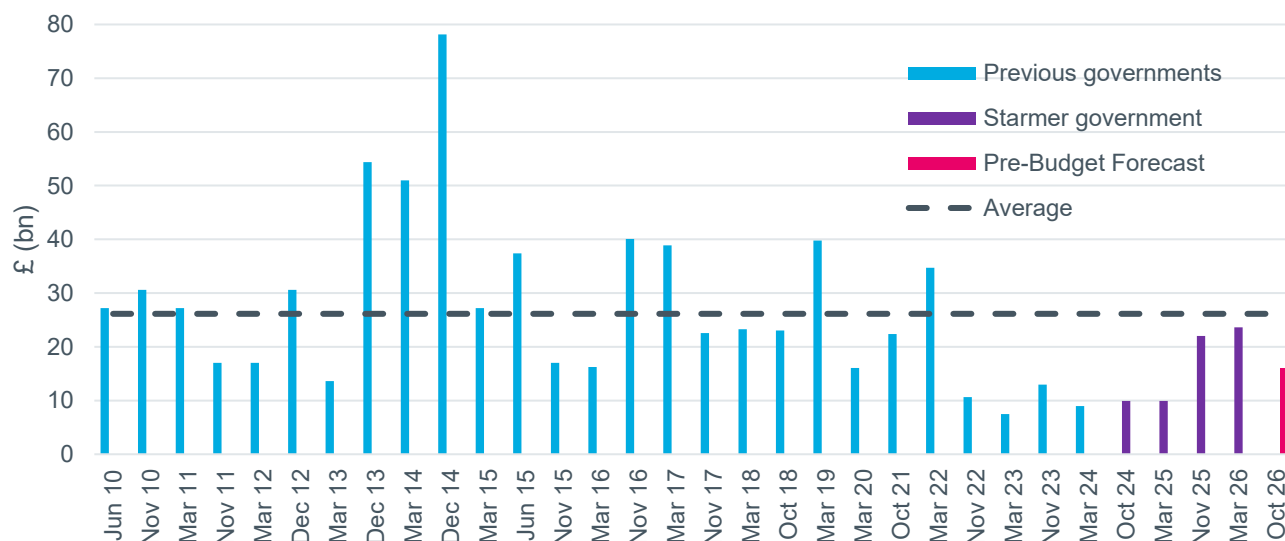
- Higher borrowing costs and other economic developments have reduced the government's fiscal headroom since the Spring, although it is still expected to retain a buffer against its fiscal rules.
- The Chancellor must balance fiscal credibility against the economic and political costs of higher taxes or lower spending. This is likely to be a smaller fiscal event than recent Budgets.
- Gilts and sterling are most exposed to Budget-day volatility. However, the global diversification of our portfolios should limit the direct impact, and we do not anticipate making portfolio changes solely because of the Budget.

The Chancellor will deliver the Budget on 28 October against a challenging global backdrop. Higher borrowing costs have constrained the government's room for manoeuvre leaving a challenging balance between fiscal credibility, spending, taxation and economic growth. We look at the options available and what the Budget could mean for investors.

The current fiscal position

The Chancellor has so far decided to retain the fiscal rules set by Rachel Reeves. These are, that by 2030, day-to-day government spending must be met by tax revenues, and government debt (public sector net financial liabilities) to GDP must be falling. The margin by which the government is meeting these rules is known as its fiscal headroom (see chart 1 below).

Chart 1: Fiscal headroom - economic conditions have likely eroded some of the inherited headroom



Source: Office for Budget Responsibility ("OBR"), Capital Economics

The Chancellor is estimated to have lost at least some of the headroom that he inherited from Rachel Reeves just from changes to economic conditions. A good proportion of this has come from higher gilt yields meaning the interest paid on government borrowing is forecast to be higher. There are multiple drivers of the higher yields that the government is facing, several of which are global in nature. For example, higher energy prices from the Middle East conflict have pushed up inflation and interest rate expectations feeding through to government bond yields, including gilt yields.

The Prime Minister has also already announced several smaller policy measures, such as the reduction in VAT on energy bills, for which funding will need to be addressed at this Budget. The major policy announcement so far has been Burnham's ambitious plan for a National Care Service. However, the notion that this can be funded through reforms to the state pension triple lock look misleading. The reforms to the triple-lock just reduce the risk of an unexpected increase to spending, it does not reduce forecasted spending. In any case, the funding for the National Care Service is likely to come further down the line, and is beyond the OBR's forecast horizon so is unlikely to be addressed at this Budget.

Chart 2: Higher gilt yields since last year's Budget has put pressure on the public finances



10-year gilt yield. Source: Bank of England

What are the government's options?

The deterioration in the fiscal position since the previous Budget means the Chancellor will need to choose between various challenging options each carrying its own economic and political costs.

Option	Potential benefits	Potential costs
Accept less headroom	Avoids unpopular tax rises or spending cuts; Some pressure may reverse if gilt yields fall	Risks losing credibility with the gilt market; leaves less protection for future shocks
Raise taxes	Improves fiscal position quickly and ensures compliance with the fiscal rules	Could worsen cost-of-living squeeze with taxes already at a multi-decade high
Cut government spending	Lowers borrowing and may demonstrate commitment to fiscal discipline if spending cuts are credible	Politically challenging to deliver and so may not be credible with the markets

Unlike in recent Budgets, the government is expected to retain positive headroom without large corrective measures. This has helped in reducing the huge amount of speculation that we saw in previous years around how the Chancellor would plug the fiscal hole. Furthermore, seeing as a lot of the fiscal deterioration has been driven by higher gilt yields, the Chancellor may be willing to accept a smaller headroom at this Budget in the hope that this may reverse following a resolution of the Middle East conflict. We therefore expect a smaller package of tax and spending measures than in recent fiscal events. Even so, investors have become increasingly sensitive to fiscal pressures in recent years. The UK saw the impact on the gilt market with the 2022 Mini-Budget. More recently, we have seen in France how investor concerns over fiscal credibility can put pressure on government bond markets.

Impact on asset classes

Gilts: We are likely to see heightened scrutiny again in the gilt market leading up to and on the day of the Budget. Simply put, if the government needs to borrow more, gilt prices may fall as yields (the interest paid to investors) rise. The gilt market has already seen a large increase in yields this year and volatility is heightened due to the ongoing Middle East conflict, adding extra pressure to the situation. Our global bond exposure should help reduce the impact of any volatility associated with the UK gilt market.

Sterling: The pound may also be impacted if investors are left disappointed by the government's fiscal credibility. Given the UK government's reliance on demand from overseas investors, any gilt selloff would most likely be accompanied by a weaker pound. Again, global diversification should help manage the impact of any sterling-related volatility.

Equities: The global equity market is unlikely to be significantly impacted by the Budget, as it is not an important event in the global context. However, currency fluctuations will have a direct impact on the pound value of overseas assets.

The UK equity market is very global in nature - around 70-75% of the UK market's revenues are generated overseas. This means the UK equity market may be indirectly impacted by any fluctuations in sterling (due to many UK-listed companies earning a significant proportion of their profits overseas, a weaker pound boosts the value of these earnings and may actually support the UK equity market). Some sectors could be directly impacted to the extent that they are targeted with taxes, for example gambling companies and banks, although rumours about these policies mean that some of the impact may already be reflected in share prices.

In summary

Investors should consider how any changes to tax rules could affect their personal circumstances and discuss these with their financial adviser. However, from an investment perspective, the global nature of our portfolios means that the direct impact of the Budget is likely to be limited.

Instead, investors should stay focused on the long-term risk and return characteristics of their investments and on the broader macro themes driving markets such as inflation, economic growth, interest rates, and secular trends like the deployment of artificial intelligence into the economy. We do not anticipate making any changes to portfolios over the Budget but will continue to monitor portfolios and markets.



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Risk warning

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