

- Most of the discussion of the UK economic outlook relates to high debt, slow growth, and elevated inflation. Despite this, perhaps **the most striking feature is the excessive fiscal policy uncertainty** that the country has now faced for some time.
- Many have pointed to the OBR's framework as the cause. The "one versus two" OBR evaluations per year debate has flooded the internet over the past weeks. However, the **real source of the uncertainty has been the low level of fiscal headroom** that this government (and its predecessor) have chosen to run.
- The consequence of low levels of starting headroom, and weak domestic and global economic activity, is **that there is now a very large fiscal black hole to fix**. The estimated size ranges from £20-40bn. This is a wide range, but even the low end of the range is a difficult sum to raise if the Chancellor keeps to her manifesto pledge on taxes.
- On November 26th, we see **three potential scenarios** for UK financial markets:
 1. **Fiscal consolidation**: we view this as unlikely to happen. While the Chancellor is clearly aware that front-loaded consolidation and greater headroom are needed, developments over recent days have demonstrated that it will be difficult to find a majority of Labour MPs to support either breaching the manifesto tax pledge or cutting expenditure meaningfully.
 2. **"Muddle through"**: this appears to be the most likely situation, where the Chancellor closes the black hole through a series of piecemeal changes to the tax system (thresholds, gambling, banks, dividends, etc). This allows her to meet her fiscal rules, but is unlikely to be sufficient to break the uncertainty cycle in financial markets (or the wider economy).
 3. **Gilt crisis**: this is currently a tail risk, given the Chancellor's repeated emphasis on fiscal credibility and the importance of fiscal rules. However, an attempt at muddling through which is not perceived to be credible by financial markets risks escalating into a gilt crisis along the lines of Truss-Kwarteng in September 2022.
- **We are positioning our portfolios for a "muddle through" scenario**, but are alive to the risk that such a scenario has the potential to escalate into a wider sell-off. We have made the following changes to our multi-asset funds to reflect our risk assessment:
 - We have **reduced sterling exposure** by 5%;
 - We have **shortened index-linked gilt duration** to <6 years;
 - We **maintain a low weighting to risk assets**, and at the margin have reduced our exposure to the FTSE 250 (which tends to sell off more aggressively in a risk-off environment) in favour of the FTSE 100.
- Overall positioning remains defensive with a focus on inflation protection. Our multi-asset portfolios currently hold 31% in managed liquidity reserve (cash, T-Bills and short-dated credit), 42% in index-linked bonds, and 27% in risk assets (which includes 1% in gold).

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