

## How currency strength became the dominant factor for markets

Today's market sell-off has been surprising, as it came off higher fiscal stimulus than expected from the UK, which should generally be positive. However, this is about currency strength, which ultimately is determined by the credibility of a government's plan. With the BOJ intervening in foreign exchange markets this week and the volatile move of sterling, there will likely be more central bank action in order to prop up their currencies. The BOJ only owns around \$60bn in foreign assets, the SNB, on the other hand, holds around \$150bn in US stocks alone. If they also were to prop up the CHF (not likely at this point), they would sell these assets. Although a sell-off was widely expected by institutional investors, there was no consensus as of what would be the trigger other than "recession". The depth of the recession will probably be determined in how to fight inflation best, for which a strong currency is always needed...

### The UK fiscal bazooka

Kwarteng's fiscal bazooka came in much larger than at least I expected... But also against my expectations, it seems to have backfired. Everything from equities to gilts and £ sold off heavily. Markets are pricing in a 50% chance of a 125bps BOE rate hike in November with a potential of an emergency hike next week to restore credibility. The message from the market is pretty clear: The need for a stronger £ is key for all UK assets, no matter how good the fiscal support could be for equities. But a stronger £ is hard to achieve with such a massive increase in borrowing. Thatcher's trickle-down economics might have worked in the 1980s when tax rates peaked and government debt/GDP were at 50%, but will it work during war times, all-time high inequality and 100% government debt/GDP? I remain of the view that the 1970s is the wrong playbook for the current environment and that the early 1920s are much more relevant, because apart from energy driven inflation, all other economic parameters are at odds between the 1970s and now<sup>1</sup>. Nonetheless, we have Jerome Powell using the playbook of Paul Volcker (1979-1987) and now Liz Truss that of Margaret Thatcher (1979-1990) while the geopolitics is extremely similar to the 1970s/80s, which is therefore an important episode to compare the current world with. An important difference between Thatcher and Truss is that Thatcher increased VAT and National Insurance contributions as well as letting

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<sup>1</sup> [www.aozorastep.com/1Q%202022.pdf](http://www.aozorastep.com/1Q%202022.pdf)

utilities increase prices while lowering income taxes<sup>2</sup>. Truss, on the other hand, has cancelled planned increases in National Insurance contributions and lowered energy bills. In effect, Truss's & Kwarteng's "mini-budget" is a Thatcher budget that is trying to eliminate all the negatives from it. The result, however, will be a swelling fiscal deficit...

#### The UK fiscal bazooka:

- 45% top rate of income tax will be scrapped in favour of single higher rate of income tax of 40% & banker bonus cap will be scrapped → good for banks
- First time house buyer stamp duty will get stamp duty exemption of up to £625k, stamp duty land tax exemption will be doubled to £250k and disposal of surplus government land to build new homes → good for developers
- VAT-free shopping for overseas visitors → good for retail, especially in light of Asia scrapping quarantine and Covid restrictions
- Duty rates for beer, wine, cider and spirits will be cancelled → good for pubs
- Corporation tax will remain at 19%, the lowest in G20 & no increase in National Insurance payments and tax relief for investment in construction, plant and machinery as well as creation of designated low tax sites → good for all businesses, especially for global businesses like manufacturing
- Energy package will cost £60bn over 6 months, package of tax cuts will cost £45bn, & £161bn over 5 years. The DMO has increased their Net Financing Requirement plan by £72.4bn from £161.7bn in April to £234.1bn now, of which £107bn is used to replace redemptions<sup>3</sup> → negative for Gilts & £
- The UK is also planning for 3% of GDP in military spending, which equates to around \$81bn. This compares strongly to Russia's planned \$84bn in 2023 defense spending

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<sup>2</sup>

[https://books.google.co.uk/books?id=7qaMqwGRE00C&pg=PA27&source=gbs\\_toc\\_r&cad=3#v=onepage&q&f=false](https://books.google.co.uk/books?id=7qaMqwGRE00C&pg=PA27&source=gbs_toc_r&cad=3#v=onepage&q&f=false)

<sup>3</sup> [https://www.dmo.gov.uk/media/pddhdwib/pr230922\\_2.pdf](https://www.dmo.gov.uk/media/pddhdwib/pr230922_2.pdf)

## UK Public Financing Revision

Financing arithmetic September 2022 update (£ billions)	2022-23 April update	2022-23 September update
CGNCR (ex NRAM, B&B, and NR) <sup>1</sup>	94.3	94.3
Additional financing for Growth Plan		72.4
Gilt redemptions	107.1	107.1
Financing adjustment carried forward from previous financial years <sup>2</sup>	-33.1	-33.1
<b>Gross Financing Requirement</b>	<b>168.4</b>	<b>240.8</b>
Less:		
NS&I net financing	6.0	6.0
NS&I Green Savings Bonds	-	-
Other financing <sup>3</sup>	0.7	0.7
<b>Net Financing Requirement (NFR) for the DMO</b>	<b>161.7</b>	<b>234.1</b>
DMO's NFR will be financed through:		
<b>Gilt sales, through sales of:</b>		
- Short conventional gilts	39.4	73.5
- Medium conventional gilts (including green gilts)	28.1	46.6
- Long conventional gilts (including green gilts)	37.3	47.0
- Index-linked gilts	19.7	21.2
- Unallocated amount of gilts	7.0	5.6
<b>Total gilt sales for debt financing</b>	<b>131.5</b>	<b>193.9</b>
<b>Total net contribution of Treasury bills for debt financing</b>	<b>30.2</b>	<b>40.2</b>
<b>Total financing</b>	<b>161.7</b>	<b>234.1</b>
DMO net cash position	2.3	2.3
<i>Figures may not sum due to rounding.</i>		
<sup>1</sup> Central Government Net Cash Requirement (excluding NRAM Ltd, Bradford & Bingley and Network Rail).		
<sup>2</sup> The -£33.1 billion financing adjustment in 2022-23 carried forward from previous years reflects the 2021-22 outturn for the CGNCR (ex NRAM, B&B, and NR), as first published on 26 April 2022. The -£33.1 billion adjustment in 2022-23 is the amount required to reduce the estimated DMO cash position at end-March 2023 to £2.3 billion.		
<sup>3</sup> This financing item is typically comprised of estimated income from coinage and unhedged reserves.		

Source: DMO

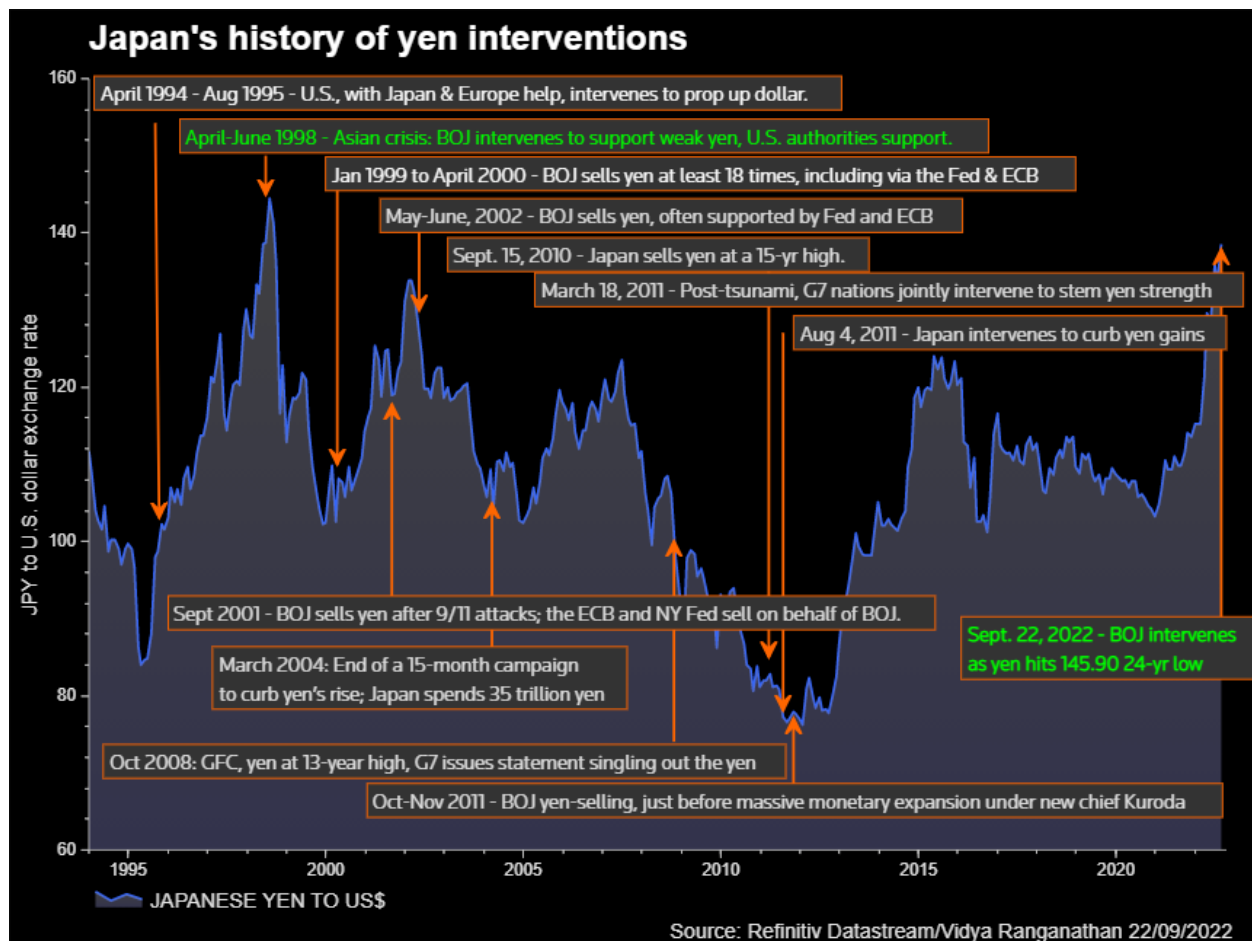
## Japan's currency intervention

This week Japan stated to have intervened in currency markets to prop up the yen. This was the first time since 1998 that Japan has sought to strengthen the yen and the second time since 1991/92<sup>4</sup>. Every intervention Japan has ever done, has in most cases eventually been successful (although there were periods when it wasn't, such as the Yen appreciation from 1993-96). The key in the success of the intervention has almost always been the coordination with the Fed and the Bundesbank<sup>5</sup>. However, this time the US is also fighting inflation and needs the strong US\$ to lower inflation and therefore the Fed is

<sup>4</sup> <https://www.reuters.com/world/asia-pacific/history-japans-intervention-currency-markets-2022-09-22/>

<sup>5</sup> [https://www.piie.com/publications/chapters\\_preview/360/11ie3519.pdf](https://www.piie.com/publications/chapters_preview/360/11ie3519.pdf)

not helping the BOJ, as it did in both 1992 and 1998. Back in the early 1980s (again Thatcher times), the US\$ appreciated by around 50% from 1980 until the 1985 Plaza Accord, which led to a general US\$ depreciation. Reagan's expansionary fiscal policy is widely seen as the reason for the appreciation of the US\$ in the early 1980s and the rejection of letting the US\$ depreciate, as it was seen as a vote of confidence in Reagan's administration<sup>6</sup>. In today's world, a strong US\$ means lower US inflation due to lower US\$ priced commodities, such as oil...



Source: Reuters

<sup>6</sup> [https://www.nber.org/system/files/working\\_papers/w21813/w21813.pdf](https://www.nber.org/system/files/working_papers/w21813/w21813.pdf)

## A stronger US\$ = lower US inflation

Although charts can be very misleading, there is a growing disconnect between oil (and other \$ priced commodities) and the US\$ exchange rate, such as EURUSD. In the US, annual inflation has peaked in June 2022 with 9.1%. The energy inflation index has risen by over 41.6%, the largest annual rise since April 1980, while the food index climbed by 10.4%. Since inflation ex-energy and food climbed by 5.9% this year, energy and food have therefore made up over 1/3 of the total rise in inflation. The Biden administration has therefore been laser focused on bringing inflation down and with the Fed stepping up rate hikes, the stronger US\$ has increased the price of oil in Europe alone by over 20% since the beginning of the year. If history is any guide, the value of the US\$ has always moved in tandem with commodities priced in US\$ - at least over the medium term. With the diversion in oil prices compared to EURUSD since the Ukraine invasion by Russia, the US\$ would need to weaken significantly to justify even current oil prices, if the correlation holds true.



Source: FRED St. Louis



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