Economic Overview (June 2022) – Provided by Link Asset Services

- The second quarter of 2022 saw:
  - GDP fall by 0.1% m/m in March and by 0.3% m/m in April;
  - An easing rather than a collapse in the composite Purchasing Managers Index (PMI);
  - A further rise in Consumer Price Index (CPI) inflation to a new 40-year high of 9.1% in May;
  - The first signs that the weakening in economic activity is filtering into a slightly looser labour market;
  - Bank Rate rise to 1.25%, taking it to its highest level since the Global Financial Crisis;
  - Gilt yields caught up in the global surge in bond yields triggered by May's strong rise in US inflation;
  - Rising global bond yields and concerns over growth drive a global sell-off in equity markets.
- Following the 0.1% m/m fall in GDP in March and the 0.3% m/m contraction in April, the economy is now moving towards a recession (two quarters of falling output in a row). Indeed, GDP would need to rise by 0.4-0.5% m/m in both May and June to prevent the economy from contracting in Q2 as a whole. That said, without the joint wind down of the COVID-19 Test and Trace and vaccination programme, GDP would have risen by 0.2% m/m and 0.1% m/m in March and April respectively. That's hardly strong, but it suggests the underlying momentum is not quite as weak as the headline figures imply.
- There is not much evidence that higher inflation and higher interest rates have yet become a big drag on activity. Services output did fall by 0.3% m/m in April. But output in consumer-facing services, conversely, rose by a solid 2.3% m/m in April. And although the Office for National Statistics (ONS) said that some of the 1.0% m/m fall in manufacturing output was linked to the drag on activity from higher prices, it also said that some of the 0.4% m/m drop in construction output in April was a drop back after the boost in the wake of February's Storm Eunice.
- The fact that the composite PMI didn't fall in June also suggests that in Q2 (Apr – June) real GDP has softened rather than collapsed. The S&P Global/CIPS all-sector PMI for June was unchanged from its level of 53.1 in May, signalling tepid but positive growth. According to the Lloyd's barometer, business confidence in May also remained remarkably resilient.
- Despite the fall in the GfK composite measure of consumer confidence to a new record low of -41 in June, April's £1.4bn rise in consumer credit suggests households appear to have turned to credit to support their spending as the cost-of-living squeeze has intensified. Meanwhile, the household saving rate held steady at 6.8% in Q1 in line with its long-term average and we expect households to lower their saving rate further when the bigger falls in real incomes come in Q2 and Q3 to cushion the blow to spending.

- The Chancellor's latest fiscal support of £10.3bn (0.5% of GDP), which comprised £15.3bn of handouts to households, partly funded by a £5bn tax on the profits of oil and gas producers, will help support GDP in the second half of the year. And with the Prime Minister and the Chancellor desperately needing to boost their popularity, some tax cuts may be announced in the Autumn Budget.
- There has been early signs that the recent weakening in economic activity is filtering through into a slightly looser labour market. The unemployment rate edged up from 3.7% in the three months to March to 3.8%. The single-month data showed that employment fell by 254,000 in April and the unemployment rate rose from 3.5% to 4.2%. And the upward march in the number of job vacancies slowed, with the three-month average only rising from 1.296m in April to 1.300m in May. A seasonal adjustment of the single-month data implies that vacancies fell in May for the first time since COVID-19 was rife in December.
- At the same time, a 1.8% m/m fall back in average earnings in April meant that the 3myy rate of earnings eased from 7.0% in March to 6.8% in April. And a lot of the 0.5% m/m rise in earnings excluding bonuses was probably due to the 6.6% rise in the National Living Wage on 1st April. The 3myy rate of earnings excluding bonuses stayed at 4.2%.
- That said, conditions in the labour market remain exceptionally tight. The unemployment rate is still close to its recent 47-year low, and there is the same number of unemployed people as job vacancies and at 6.8% in April, the 3myy rate of average earnings is at a 10-year high (although it is still falling in real terms) and is well above the 3.0-3.5% that is broadly consistent with the 2.0% inflation target (assuming that productivity growth is 1.0-1.5%).
- CPI inflation rose from 9.0% in April to a new 40-year high of 9.1% in May and it is not yet close to its peak. The increase in CPI inflation in May was mainly due to a further leap in food price inflation from 6.7% to a 13-year high of 8.5%. With the influence of increases in agricultural commodity prices yet to fully feed into prices on the supermarket shelves, we think that food price inflation will rise above 10% in September. And with two-thirds of the observation period for the Ofgem price cap having now passed, something like a 40% rise in utility prices is pretty much baked in the cake for October. The further rise in core producer price inflation, from 13.9% to 14.8%, suggests that core goods CPI inflation will probably rise to 14% before long. We think that will take CPI inflation to a peak of around 10.5% in October.
- The rise in services CPI inflation from 4.7% in April to 4.9% in May suggests that domestic price pressures are still strengthening.
- There now seems to be an even greater likelihood that second-round effects, whereby high inflation feeds back into higher price and wage expectations, keep inflation higher for longer. For some time, the Monetary Policy Committee (MPC) has placed a lot of weight on the results of the Bank of England's monthly Decision Maker Panel which asks businesses how they expect to change their prices and wages over the next year. May's survey revealed that businesses still expect to raise their selling prices by 6.0% and their wages by 4.8% over the next year. Meanwhile, XpertHR said that pay settlements across the economy stayed at a 30-year high of 4.0% in May. The government appears to be contemplating raising public sector pay by up to 5%. And the 7.1% pay rise granted to some

railway workers sets a high bar for the negotiations that led to train strikes across large parts of the country in mid-June.

- The MPC has now increased interest rates five times in as many meetings and raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Fed raised rates by 75 basis points (bps) in June and a handful of other central banks have recently raised rates by 50bps, the Bank of England's action is relatively dovish. The MPC's decision not to follow the Fed and raise rates by more makes some sense. The UK's status as a larger importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.
- But the MPC's new guidance is that if there are signs of "more persistent inflationary pressures" it will, "if necessary act forcefully in response". We expect the MPC to continue to raise rates in steps of 25bps rather than 50bps. We think the MPC will raise rates from 1.25% now to a peak of 2.75% next year. That's higher than the peak of 2.00% forecast by economists, but lower than the peak priced into the financial markets.
- Gilt yields have been caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. And in response to signs that central banks (particularly the US Fed) are going to raise interest rates faster to get on top of inflation, we now think that 10-year gilt yields will reach a peak of 2.70% (up from 2.39% currently) this year and into 2023.
- While the S&P 500 is 8.4% below its level a month ago, the FTSE 100 is 5.7% below it. Part of the sell-off has been driven by the rapid rise in global bond yields and the resulting downward pressure on equity valuations as well as concerns over economic growth.
- Finally, the pound has already weakened from \$1.37 and €1.21 earlier this year to \$1.21 and €1.16. A lot of these moves have been driven by concerns over the outlook for the global economy and the resulting poor performance of risky assets, which has increased the demand for the dollar relative to sterling. If interest rates rise faster and further in the US than in the UK, rate differentials and a worsening in risk appetite will push the pound even lower, from \$1.21 now to \$1.18 by the end of 2022. We don't expect the pound to fall by as much against the euro (from €1.16 to €1.14 next year). But once global inflation and global interest rates peak, the pound will probably benefit from the return of risk appetite. It may rise to \$1.25 by the end of 2023 and to \$1.30 by the end of 2024.

MPC meetings 5th May and 16th June 2022

- After the Bank of England became the first major western central bank to put interest rates up in this upswing in December, it has quickly followed up its first 0.15% rise by a further four 0.25% rises to 1.25%, in what is very likely to be a series of increases repeated throughout the rest of 2022 and into 2023.
- In May, the MPC voted 6-3 vote in favour of a 0.25% increase, but not only was this the first time in its 25-year history that the MPC had raised rates at four meetings in a row but also three members (Haskel, Mann and Saunders) wanted

a 0.5% hike (up from none in March). However, GDP growth was forecast to drop to -0.25% in 2023 (+1.25% previously) and only +0.25% in 2024 (+1.00% previously). Anyone for a recession?

- Nonetheless, over Q2, it is clear central banks in the developed economies have placed the dampening down of inflation pressures front and centre of their primary objectives, even if it comes at the cost of sluggish growth or, indeed, recession (mild ideally but it is very difficult to micro-manage economic performance). The Monetary Policy Committee (MPC) is in step with this approach although, arguably, the UK economy is dragging its feet to a greater extent than that seen in the US.
- What are the key factors for consideration? First, the CPI measure of inflation is already at 9.1%, and the Bank of England anticipates it will peak near to 11% just before Christmas. With the cost-of- living squeeze in full swing by that juncture, and unemployment likely to be ticking upwards, we judge that the Bank will pause following its March 2023 meeting and judge it has done enough so long as inflation starts to fall, albeit at a slow pace. To that extent, we can envisage the MPC waiting a full year before loosening the reins and starting to cut Bank Rate in spring 2024. However, given the number of geopolitical factors that could push this forecast off track, we would caution against taking a strong view on how interest rate movements evolve and instead focus on optimising balance sheet management and the risk management of investment and debt portfolios.
- Regarding gilt yields, all developed economies have seen a considerable uplift in government bond yields across the whole curve since the start of 2022 and, in many ways, gilts have simply played catch-up of late. To that end, we have revised our PWLB forecasts upward and you will even see we have a 3.7% PWLB rate projected for the 25-year part of the curve in both 2022 and 2023. However, as headline inflation falls back, we project a slow reduction in gilt yields as investors acknowledge that price pressures are gradually coming under control.
- At the 16th June MPC meeting, part of the reason for the Committee only seeing a 0.25% hike as necessary is the prevailing weak economic data. The vote was again 6-3 (the same as in May) but the words were more hawkish with the Bank strengthening its forward guidance. It deleted the previous phrase that “some degree of further tightening…may still be appropriate” and replaced it with “the scale, pace and timing of any further increases in Bank Rate will reflect the Committee’s assessment of the economic outlook and inflationary pressures” and that “the Committee will be particularly alert to indications of more persistent inflationary pressures, and will, if necessary, act forcefully in response.”
- Whereas in May two members objected to the guidance that rates will rise further, it appears that all members are behind this new, stronger guidance. However, the growing evidence that firms’ price and wage expectations have become dislodged from the 2.0% target suggest that the Bank is between a rock and a hard place in navigating the appropriate monetary policy response. As always, the economic data will be key to anticipating whether our assumptions remain sound.