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

- The third quarter of 2022/23 saw:
  - A 0.5% m/m rise in GDP in October, mostly driven by the reversal of bank holiday effects;
  - Signs of economic activity losing momentum as households increased their savings;
  - CPI inflation fall to 10.7% in November after peaking at 11.1% in October;
  - A small loosening in the labour market which pushed the unemployment rate up to 3.7% in October;
  - Interest rates rise by 125bps over Q4 2022, taking Bank Rate to 3.50%;
  - Reduced volatility in UK financial markets but a waning in global risk appetite.
- GDP fell by 0.3% q/q in Q3 2022 (ending 30th September), which probably marked the start of the UK recession. About half of that decline was the effects of the extra bank holiday in September for the Queen's funeral. The unwinding of those bank holiday effects meant that GDP rebounded in October and explained at least 0.3 percentage points (ppts) of the 0.5% m/m rise. Accordingly, if GDP were to avoid falls of more than 0.2% m/m in November and December, then GDP over Q4 as a whole could avoid a contraction, which would prevent a recession in 2022.
- However, at 49.0 in December, the flash composite activity PMI stayed below the "boom-bust" level of 50 and pointed to a small 0.1% q/q contraction in GDP in Q4. Consumer confidence was -42 in December and stayed close to its record low of -49 in September. Strike action could be another small drag and may mean that GDP is 0.0% to 0.5% lower than otherwise in December. GDP is projected to contract marginally in Q4 by around 0.1% q/q.
- Meanwhile, the 0.4% m/m fall in retail sales volumes in November only reversed some of the 0.9% m/m rise in October. That left sales volumes 4.5% below their level at the start of the year. Indeed, the rise in the household saving rate from 6.7% in Q2 to 9.0% in Q3 implied that higher interest rates are encouraging households to save more. And a larger-than-usual £6.2bn rise in cash in household bank accounts in October may imply households have started to increase their precautionary savings.
- There were signs that the labour market was loosening gradually going into the final quarter of 2022. Although employment in the three months to October rose by 27,000, the fall in the composite PMI employment balance in December took it into contractionary territory and suggests that labour demand will cool. Meanwhile, labour supply improved as inactivity fell by 76,000 in the three months to October. That helped drive a rise in the unemployment rate from 3.6% in September to 3.7% in October. The number of job vacancies in November fell for the sixth consecutive month and were 18% below their peak in May.
- Crucially, though, wage growth remained resilient. Average earnings growth, excluding bonuses, grew by 0.7% m/m in October, above the 2022 monthly average of 0.5% m/m. That drove the 3myy rate up to 6.2%, well above the rates of 3-3.5% consistent with inflation at its 2% target. Wage growth is likely to slow gradually in the coming months as the labour market loosens further but if extensive strike action is successful in achieving large pay increases, then wage growth could be a bit stronger for longer.
- CPI inflation peaked in October at a 41-year high of 11.1% and fell to 10.7% in November. Goods price inflation, which is driven largely by global factors, has peaked. The sharp rises in energy prices in 2022 mean that energy price inflation will fall sharply in 2023. Meanwhile, the large fall in agricultural prices since May means that food price inflation should start to decline soon. What's more, upward pressure on goods price inflation from global supply shortages is fading quickly.
- Domestic inflation pressures also eased in Q4. The 0.2% m/m rise in core CPI inflation in November was the smallest monthly gain since August 2020 and drove a fall in core CPI inflation from 6.5% in October to 6.3% in November. Services CPI inflation was stable at 6.3% in November despite the resilience of wage growth. And the easing of price expectations in the Bank of England's Decision Maker Panel survey in November suggests that inflation may become less persistent.

- The Chancellor's Autumn Statement on 17th November succeeded in restoring the government's fiscal credibility in the eyes of the financial markets without deepening the recession. The total fiscal consolidation package of £54.9bn (1.8% of GDP) in 2027/28 made the outlook for fiscal policy much tighter than at the beginning of Q4. The package was heavily backloaded, with net handouts of £3.8bn (0.15% of GDP) in 2023/24 and £0.3bn (0.01% of GDP) in 2024/25, and most of the tightening kicking in after 2024/25. The largest fiscal support was the extension of the Energy Price Guarantee for another 12 months, until April 2024, although at a higher price cap of £3,000 from April 2023 rather than £2,500. At the same time, Chancellor Hunt loosened the fiscal rules by requiring debt as a percentage of GDP to be falling in five years' time, rather than three. The Office of Budget Responsibility (OBR) estimated that the Chancellor will meet this new rule with a slim £9.2bn (0.3% of GDP) to spare.

- With fiscal policy now doing much less to fan domestic inflation pressures, we think Bank Rate will peak at 4.50%, or at least close to that figure. Despite stepping up the pace of policy tightening to a 75-basis point (bps) rate hike in November, taking Bank Rate from 2.25% to 3.00%, the MPC's communication was dovish. The MPC pushed back heavily against market rate expectations, which at the time were for Bank Rate to peak at 5.25%. The Bank's new forecasts predicted a deeper and longer recession than the analyst consensus, of eight quarters and with a peak-to-trough fall in real GDP of 2.9%.

- The Bank sounded dovish again in December when it slowed the pace of tightening with a 50bps rate rise, from 3.00% to 3.50%. Two members, Dhingra and Tenreyro, voted to leave rates unchanged, judging that the current level of Bank Rate was sufficient to bring inflation back to target. That said, the rest of the MPC appeared to suggest that further rate hikes would be necessary. We expect that the majority of the MPC will need to see stronger signs that activity is slowing, the labour market is loosening, and wage growth is slowing before stopping rate rises. As such, we expect that the MPC will deliver three further rate hikes in February, March and May, taking Bank Rate to a peak of 4.50% but with the pace of increase reducing to 25bps in March and May.

- Gilt yields have fallen sharply since their highs following the "mini-budget" on 23rd September as government fiscal credibility has been largely restored with the resignation of Truss-Kwarteng and the fiscal consolidation package announced at the Autumn Statement on 17th November. Indeed, the 10-year yield fell from a peak of 4.55% to about 3.60% now, while the 30-year yield fell from 5.10% to 3.90%. Admittedly, yields rose by around 50bps in December, partially on the back of a global rise in yields. But if we are right in thinking Bank Rate will fall back in 2024 and 2025 then gilt yields will probably fall over the next two years, with the 10-year yield slipping from around 3.60% now to 3.30% by the end of 2023 and to 2.80% by the end of 2024.

- Lower volatility in gilt markets in Q4 meant that the Bank of England was able to stop its purchases of long-term gilts for financial stability reasons as planned on 14th October. It was also able to begin active gilt sales in November, albeit with a focus on shorter dated gilts. So far quantitative tightening has had little influence on short-term money markets. But as it is still an experiment, the risk of a widespread tightening in financial conditions remains.

- The restoration of fiscal credibility boosted the pound and the FTSE 100 early in Q4. While much of the benefit passed in the first half of Q4, sterling continued to rally against a softer dollar. Our colleagues at Capital Economics do not think that the global recession is fully priced into markets, and so expect a further fall in risk appetite to boost safe haven demand for the dollar and weigh on the pound. They are expecting the pound to fall from $1.19 now to $1.10 in mid-2023, before climbing to $1.15 by the end of 2023 as the prospect of lower interest rates and a recovery in global economic growth buoys equity prices.

- Through December, the rally in the FTSE 100 petered out as investors have become increasingly concerned by the prospect of a global recession. However, the relatively dovish tone of the Bank of England, compared to the Federal Reserve and the ECB meant that UK equities held up better than other developed market indices. Indeed, at 7,452 at the December month end, the FTSE 100 is only marginally below its peak of 7,568 on 5th December, while the S&P 500 is around 4% lower over the same period. Nevertheless, there is a great deal of uncertainty as to which direction markets will move in 2023 and at what pace. Continued volatility is anticipated.

MPC meetings 3rd November and 15th December 2022

- On 3rd November, the Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 75 basis points to 3.00%, and on 15th December moved rates up a further 50 basis points to 3.50%. The later increase reflected a split vote – six members voting for a 50 basis points increase, one for 75 basis points and two for none.
- Nonetheless, the UK government appears more settled now, with Rishi Sunak as Prime Minister, and Jeremy Hunt as Chancellor. Having said that, a multitude of strikes across several public services and the continued cost-of-living squeeze is going to make for a difficult backdrop to maintain fiscal rectitude without pushing the economy into anything worse than a mild recession.
- Of course, what happens outside of the UK is also critical to movement in gilt yields. The US FOMC has led with increases of 425 basis points in 2022 and is expected to increase rates further in 2023. Similarly, the ECB has also started to tighten monetary policy, albeit from an ultra-low starting point, as have all the major central banks apart from Japan (although the BoJ has "tightened" its policy by widening the accepted yield levels for 10yr JGBs, from 0.25% to 0.5% on 20th December). Arguably, though, it is US monetary policies that are having the greatest impact on global bond markets.
- What happens in Ukraine will also impact the global economy, but particularly in Europe. The search for alternative providers of energy, other than Russia, will take both time and effort. The weather will also play a large part in how high energy prices stay and for how long.