Focal Point

UK: stagflation ahead

Authors: Christoph Siepmann, Florian Späte

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Our Focal Point series explores topical issues on macro, markets, and investment

- After the BoE's Monetary Policy Committee (MPC) delivered a 4th hike of Bank Rate to 1% in May, we expect another two to 1.5% in June and August and a third this autumn or early next year. The latter will depend on the cooling of the labour market. We remain below market expectations but are broadly in line with consensus forecasts.
- The BoE faces a stagflation dilemma. The "cost-of-living" crisis will push the UK economy close to stagnation. Supply-side driven inflation will stay high for longer which the MPC is unable to prevent. Instead, the BoE will concentrate on managing inflation expectations. We expect the labour market to cool sooner rather than later.
- The outperformance of Gilts versus other major government bond markets is likely to continue in the months to come. Given the significant drop in inflation longer term and our cautious key rate outlook compared to market pricing, we see only limited scope for a further yield increase across the curve.

Early May, the Bank of England's Monetary Policy Committee (MPC) decided to raise Bank Rate by 25 bps to 1%. The decision was taken by a majority of 6-3, with three members preferring an increase by 50 bps. While the rate hike was widely expected, the dissenting views were not anticipated by the consensus. Increasingly divergent opinions are also evident from two MPC members who did not want to signal further hikes. The forward guidance now reads that "most members of the Committee judge that some degree of further tightening in monetary policy may still be appropriate in the coming months". The BoE also announced to work on a strategy for UK government bond sales (quantitative tightening, QT) as the previously defined threshold of 1% has been reached. The MPC will provide an update at its August meeting. The BoE has made it clear that it will not use QT as an outright policy tool.

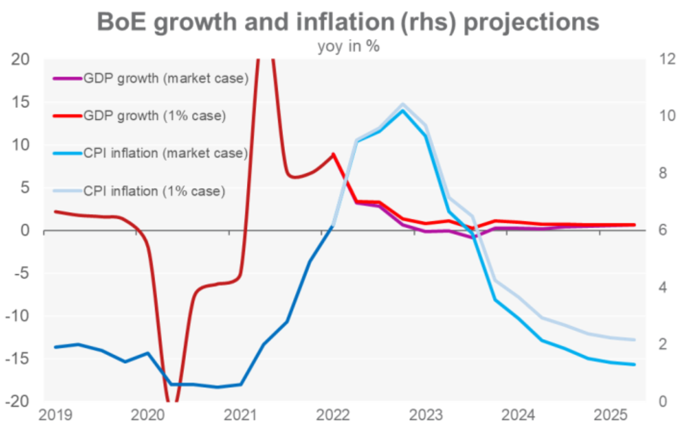
"Cost-of-living" crisis already taking its toll

The MPC decision took place against a weakening macro data backdrop. While the Covid recovery is fading out, the "cost-of-living" crisis is aggravating amid strongly rising inflation. March retail sales receded by 1.4% mom but recovered in April. GfK consumer confidence slumped to a record low in May. The service PMI cooled rapidly. While overall UK GDP expanded by 0.8% qoq in Q1 (BoE forecast 0.9% qoq), the UK Office for National Statistics' monthly estimate sees growth to have contracted in March by 0.1% mom. The BoE expects activity to already stagnate in Q2, given the blow to UK household income. It is estimated that households face "a £1,700 increase in 'necessary' costs (taxes, energy and food), equivalent to a drop of 5.1% in gross income over the coming twelve months […]". Its main driver, inflation, increased to 9% in April (the highest level since 1982) and the BoE expects it to peak at slightly over 10% in Q4 (see Monetary Policy Report, May 2022). Much of inflation is "imported", i.e. a negative terms of trade effect and thus primarily exogenous. Recently, this included the negative energy/supply side shocks from Russia's invasion of Ukraine and fresh hits to global supply chains from China's lockdowns. According to the BoE, goods and energy prices account for about 80% of the overshoot in CPI inflation.

BoE model suggests stagflation case ahead

However, monetary policy focusses on the medium-term outlook. The BoE incorporated the market implied Bank Rate (rising to 2.6% by mid-2023 and up from 1.4% in the February version) as well as oil and gas future prices for six months (then held flat implying the inflation effect to drop out after one year) into its model calculations.

Based on these assumptions, the model basically predicts a stagflation case. The model result is not to be confused with a BoE forecast as the MPC will follow its own rate path. However, given the market assumptions, model growth drops from 3¾% this year into stagnation in 2023 and 2024. CPI inflation remains sticky. After 10¼% this year, it remains high with an average of 6.4% and 2.2% in 2023 and 2024. Compared to February, inflation stays higher despite the Bank Rate increase by 120 bps. The stagnation is expected, although the model assumes that growth will still "benefit" from a temporary 3pp reduction in the household savings rate to 3.5%, the lowest level since 1999. The unemployment rate is seen to rise to 5.5% towards the forecast horizon. Finally, the BoE also reveals the model results if the 1% Bank Rate were maintained. Then, growth would soften to around 0.8% (no recession but still the impact of the cost-of-living crisis and past Bank Rate hikes), but inflation would remain elevated at around 3% in 2024.



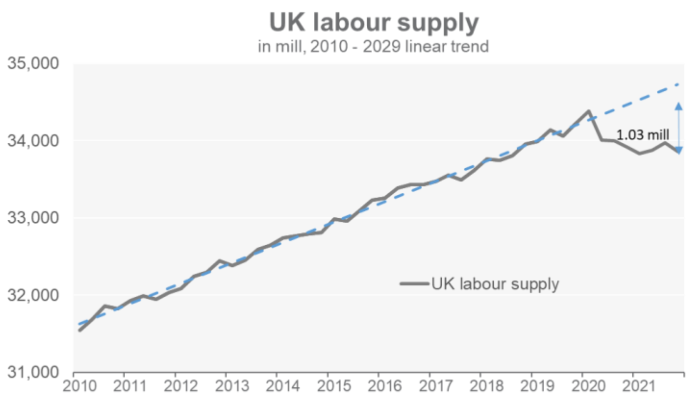
Source: Bank of England, Datastream, GIAM calcualtions

The BoE stagflation dilemma

In sum, the BoE suffers from a true stagflation dilemma. Growth has already weakened due to the real income squeeze, while the cost-push-caused inflation remains high. Bringing this "imported" inflation down would require supressing domestic demand to a compensating deflation case. As we repeatedly pointed out, keeping inflation in check will not come without large costs. The MPC must choose between two evils. Formally, the MPC sticks to its remit. However, Governor Bailey said: "The most important thing we can do is to get inflation back to target and to get back to target without unnecessary disruption to the economy". Thus, in practice, recession risks also carry some weight. In fact, there is no "optimal" path for the BoE. We expect the BoE to remain below the market path due to the following reasons:

First, the supply side shocks are beyond the influence sphere of the BoE. In "normal times" with one shock only, the inflationary impact would largely drop out of statistics after one year on base effects. Thus, provoking a recession would not be justified. Now, the BoE faces repeated shocks (Covid, energy prices, Ukraine war, supply chain disruptions, labour supply) with their outlook particularly uncertain. Nevertheless, compared to consensus (CPI 2023 at 3.9%) and ours the BoE's inflation path is on the hawkish side. Thus, a stronger base effect could allow more benign rate hikes than the market projects.

Second, we expect the labour market to cool sooner rather than later: Fundamentally, given the repeated shocks the MPC must prevent high inflation to become entrenched in expectations, also in the form of a wage-price spiral. Labour market data are still strong, due to diminished labour supply and the (now fading) Covid recovery. Regular pay growth has slightly increased to 4.2% of late. Unemployment has dropped further to 3.7% and vacancies are on high levels. The BoE expects the labour market to tighten further near term. However, the labour market is typically a lagging indicator. The falling participation rate also implies a shift in relative prices of labour, which the BoE should not fight. The BoE model suggests real post-tax labour income to fall by 3¼% this year and another ¼% in



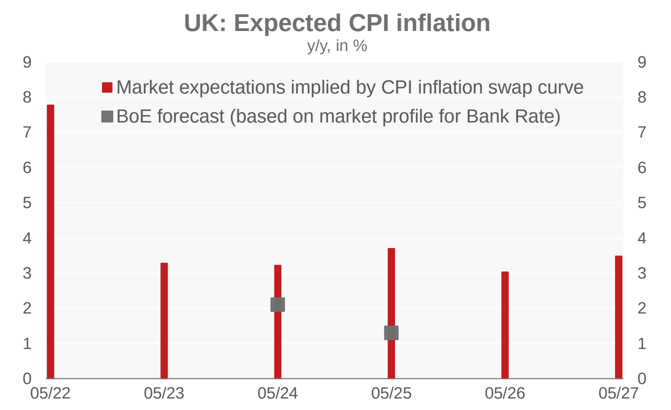
Source: Oxford Economics, GIAM calcualtions

2023 while average weekly earnings growth remains rather high. However, the impact of the supply shock could fade out. We see the savings rate assumption as rather optimistic, and thus the labour market cooling may be more pronounced. Again, this could allow the MPC to stay below the market path.

All in, we expect the BoE to raise Bank Rate by two 25 bps steps until August. Depending on the labour market a third step could follow in Q4 or early next year. Recession risks will increasingly dominate the discussion. Hence, we stay considerably below market expectations (which currently peak around 2.5% in mid-2023) due to a more benign inflation path, the expectation of a stronger cooling of the labour market as well as the model forecast of an undershoot in inflation to 1.3% by Q2 2025. However, we are close to the consensus forecast (and close to our February Focal Point). Consensus forecasts sees Bank Rate at 1.5% by Q1 2023, and 1.75% by end 2023. We see inflation at 8.4% and 5.3% in 2022 and 2023 and expect growth to slow from 3.5% this year to 0.6% next year. Risks for Bank Rate are tilted to the upside given the uncertainty around energy supply and the lockdowns in China. Regarding QT, we continue to expect the BoE to start on a very limited level of £0.5 bn to £1 bn per week after the August MPC meeting.

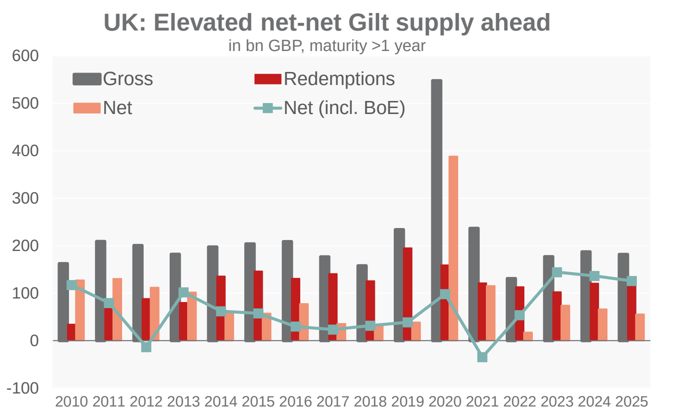
UK government yield curve to flatten again

Although priced future key rate expectations have risen significantly since the release of our latest Focal Point on the BoE in February, short-dated yields have hardly increased on balance. On the contrary, long-dated UK yields have risen significantly over the last three months. Hence, our expectations of a re-steepening of the UK yield curve have thus already been fulfilled. Despite the rise in yields at the long end of the curve, UK Gilts have outperformed international peers across the curve.



Source: Bloomberg, GIAM calculations

Going forward, we think there is some leeway for UK yields to rise slightly in the months to come but less than e.g. Bund yields. As explained above, we consider current market pricing for future key rate hikes to be overly ambitious. A key rate peak around 2.50% in 2023 and still above 2.0% going into 2025 does not correspond to the BoE's 3-year ahead CPI forecast of 1.3% (see chart above). As explained, we therefore do not expect the BoE to raise key rates to the extent currently being priced. That said, the current yield level of below 1.50% for 2-year Gilts appears slightly too low, as rate fears will persist or climb as inflation actually prints higher. Currently, forwards price an increase of more than 25 bps for 2-year Gilts on a 2-year year horizon to around 1.70%. According to our models applying current market pricing for future key rates implies an even higher level. Assuming the BoE follows the path mapped out by financial markets and calculating yield levels from discounted key rate expectations 2-year yields would have even leeway to rise well above 2.0% until the end of the year. Given our more cautious BoE expectations, we consider this to be far too high and regard current forwards to be the maximum level that 2-year yields can achieve in the foreseeable future.



Source: Bloomberg, DMO, GIAM calculations

The leeway for long-dated UK yields to rise more, however, looks even more limited. The split views within the MPC indicate that financial markets pricing in a further 150 bps of hikes looks exaggerated. Looming recession risks in an environment of elevated inflation to a large extent caused by factors beyond the central bank's influence will limit future key rate hikes. While the 2-year ahead CPI forecast will allow for some further hikes the lowest 3-year ahead CPI forecast for more than a decade clearly signals an earlier end of the cycle than currently priced. Our models show that the current 10-year yield level largely corresponds to the fair value. While future key rate hikes and elevated inflation indicate some leeway for higher yields, the weak growth outlook and the poor consumer confidence limit a further rise. Our fair value models indicate a 10-year yield level of 1.95% on a 12-month horizon. Accordingly, we do not expect forwards for 10-year UK yields (2.05% and even 2.15% on a 1-year and 2-year horizon, respectively) to be achieved. On balance, we expect a sideways trend until year-end. Hence, the yield curve steepening trend which has started in mid-February is likely to have passed its peak.

Two caveats remain, however. First, particularly longer-dated UK yields will also be driven by global government bond markets. As other central banks still have a long way to go and the high uncertainty about the persistence of inflation (particularly in the US) Gilts are unlikely to emerge from a sell-off on international bond markets unscathed. Second, the technical situation remains tight going forward. The BoE will not reinvest £37 bn in 2022 and a similar amount next year. Moreover, QT will lead to a further increase in net supply in the low double-digit billions per year which will only partially be balanced by lower fiscal deficits. Overall, we expect net-net supply to reach a new record high in 2023 and to recede only slowly thereafter. However, the facts are known, and the BoE has already announced that it will reduce its portfolio in a market -friendly manner.

Overall, given the high degree of uncertainty regarding the macroeconomic developments and the BoE's reaction function, our conviction regarding the near end of the Gilt sell-off is not very pronounced. In our base scenario, we expect a range trading of long-dated UK yields for the time being and do not recommend going outright long Gilts despite the explained mispricing of future BoE hikes. However, in a bearish bond market environment we expect Gilts to outperform other international government bonds. Particularly, the spread to 10-year German Bund yields (currently 95 bps) has more leeway to tighten going forward. The ECB has not yet started its hiking cycle and EA 5y3m OIS at 1.5% (closely correlated with 10-year Bund yields) signal further leeway for Bund yields to rise. Additionally, the 10-year Bund premium might rise further (currently at levels of 2017/18). A looming swing to a positive deposit rate and the approaching end of QE (and further down the road even the start of QT) appear not adequately priced in. If anything, this will support a rise in long-dated Bund yields as well.

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