UK UPDATE - BANK OF ENGLAND'S RUSH JOB ON INFLATION

TRUCK DRIVER SCARCITY FORCES THE HAND OF THE OLD LADY OF THREADNEEDLE STREET

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SUMMARY

- The Bank of England (BoE) has been turning hawkish amid rapidly rising inflation. A chorus of Monetary Policy Committee members has signalled that rate hikes are approaching, driven by a desire to nip in the bud the risk of second-round effects arising from the recent hike in inflation.
- We are updating our BoE scenario: we now predict a technical rate hike of 15bps in the next two months (most likely in November), followed by another 25bps hike in Q1 2022 and then a pause.
- Raising rates would break our macro 'model' for the Bank of England. This assumed the BoE would not go solo before the Federal Reserve (which we do not see pushing up rates before 2023). In our model, BoE interest rates are mostly a consequence of Federal Reserve and European Central Bank policy.
- A BoE rate hike at this point in time looks to us a risky move given a rapidly deteriorating domestic economic outlook and a growing energy crisis, as well as the deteriorating EU-UK relationship over Northern Ireland's trade status.
- Furthermore, there is limited data available about the effects of the end of the jobs furlough scheme in September; the BoE is very much groping in the dark at this stage.
- We are keeping our 2021 UK growth forecast at 6.5% (versus 7.0% consensus) while mindful that the recovery has, at best plateaued. Macro risks are to the downside. We think the bumpy road the UK economy is facing in the coming months will cause the Bank of England to halt rate hikes in Q2 2022.
- Our UK consumer inflation forecast of 2.7% in 2022 is under review for upgrade due to spiralling energy prices. But we struggle to see second-round effects materialising and inflation becoming more persistent in 2023 --although "bad inflation" caused by post-Brexit trade frictions could mean it stays higher than in other peer countries in the longer run.

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Brexit is also to blame for high UK inflation

After a rapid global recovery, helped by considerable fiscal and monetary stimulus, lingering Covid-19 disruptions in some countries (especially big manufacturing centres in Asia) have led to **sharp bottlenecks in some sectors as well as rapid rises in global commodity prices**.

In the UK, inflation has been exacerbated by the **country's formal exit from the EU** in January 2020, which has further disrupted already strained supply chains. A particularly acute shortage of **truck drivers** has emerged due to a mix of working conditions, delays in training caused by the pandemic and new immigration restrictions. **The shortage of drivers has led to interruptions in the supply of some food items to supermarkets and, more recently, of fuel to some petrol stations.**

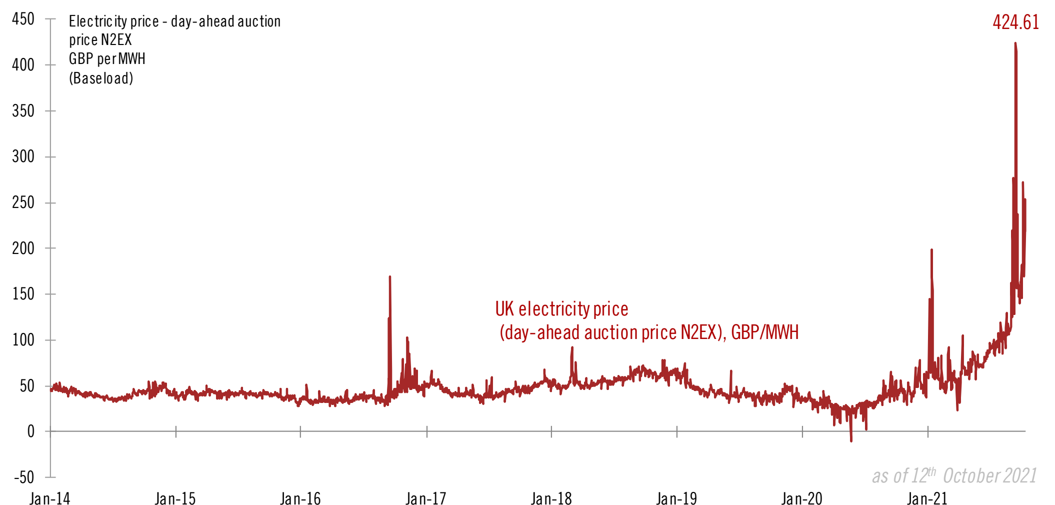
All these developments have resulted in a sharp rise in prices. After UK CPI inflation accelerated to 3.2% y-o-y in August 2021, the Bank of England (BoE) said it expected CPI to rise to 4% in the fourth quarter "owing largely to developments in energy and goods prices".

Some members of the BoE's Monetary Policy Committee (MPC) have since expressed their **worry that 'temporary' inflation in the UK could become more entrenched**. These members fear that inflation may not fall back substantially in 2022, especially if heightened inflation expectations turn out to be a self-fulfilling prophesy.

Indeed, **market expectations for future inflation have continued to edge up** in recent weeks: current pricing (based on inflation-linked bonds) is for UK inflation to average c. 3.9% over the next five years (versus 3.3% expected at end-June).

The BoE does not seem to have bought into recent economic research that questions the role of price expectations in actual inflation (cf '*Why Do We Think That Inflation Expectations Matter for Inflation*?', Jeremy B. Rudd, Federal Reserve Board research paper 2021-062).

CHART 1: THE UK FACES A SHARP ENERGY (AND ELECTRICITY) CRISIS



Source: Pictet WM - AA&MR, Bloomberg, as of 12 October 2021.

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Faced with rising inflation expectations, the Bank of England believes it is time to act.

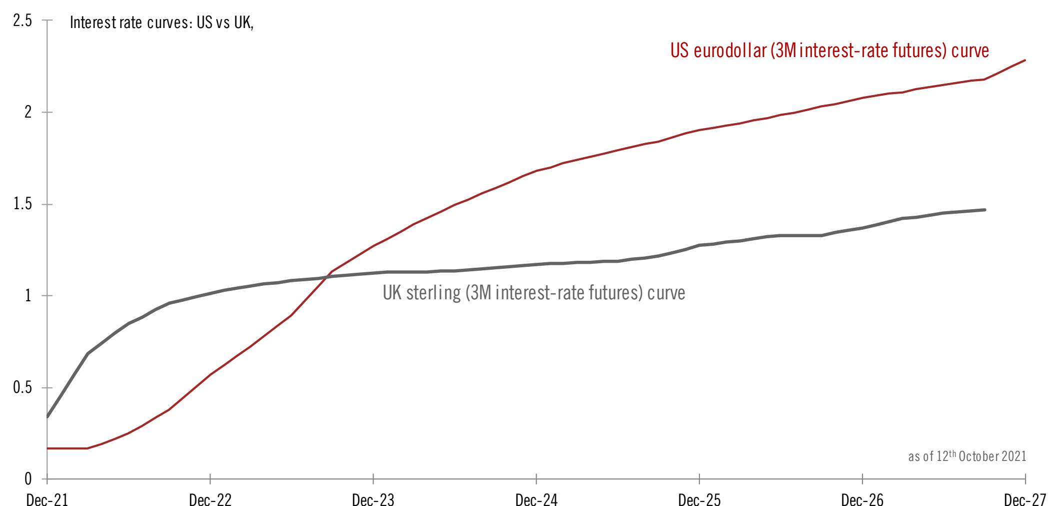
Along with the challenge of rising inflation, the Bank of England, like other central banks, is **probably suffering from 'QE fatigue'** after two years of exceptional policy support to deal with the covid-19 crisis.

In addition, there has been criticism of the BoE's accommodative stance within the UK. For instance, the House of Lords issued a rather harsh report entitled 'Quantitative easing: A dangerous addiction' in July 2021. By considering an early rate hike, **perhaps the Bank of England wants to show that it can avoid the kind of liquidity trap**, when monetary policy becomes ineffective, described in the House of Lords report.

Still, **this sudden determination to rush through with rate hikes is puzzling economic observers**, ourselves included. There is still limited data about the economic impact of the end of the job furlough scheme in September. Meanwhile, the UK economy's growth prospects are being hit by the current disruptions, even though this hit is not yet obvious in PMI business surveys. Still, GDP grew a measly 0.1% in August from the previous month, showing the slowdown started before supply-chain bottlenecks became really acute in recent weeks. BRC retail sales fell 0.6% y-o-y in September, from +1.5% in August. Meanwhile, **there is a genuine energy crisis unfolding**—visible as much in sharply rising wholesale electricity prices as in petrol shortages *(see chart 1)*—that could further stress **consumer sentiment and reverberate on consumption**.

Our fundamental macro model takes into account the reaction function of BoE monetary policy since 1998. **This reaction function has generally taken its cue from Federal Reserve and (especially) European Central Bank policy since then**. Yet for now, the latter **two central banks still appear relatively serene about inflation risks**, unlike the Bank of England. By hiking rates so soon, the BoE is about to go against its traditional reaction function.

CHART 2: THE BANK OF ENGLAND IS SEEN HIKING RATES UP TO 1% AND THEN SLOWING



Source: Pictet WM - AA&MR, Bloomberg, as of 12 October 2021.

The hawkish signalling from the Bank is however forcing us to change our scenario and abandon our models. We now forecast the BoE will hike rates by 15bps before the

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end of the year, most likely at the **November MPC meeting**, when the BoE also releases its quarterly inflation report. A 15bps hike would bring rates up to 0.25%. **A further 25bps hike looks to be on the cards in Q1 2022.**

We are likely to see further signs that UK growth is on a fragile footing in the first half of 2022. **We think the Bank of England will decide in Q2 2022 to pause tightening**, especially as a downdraft in growth could depress inflation expectations. The question then could be whether it was really worth hiking interest rates twice.

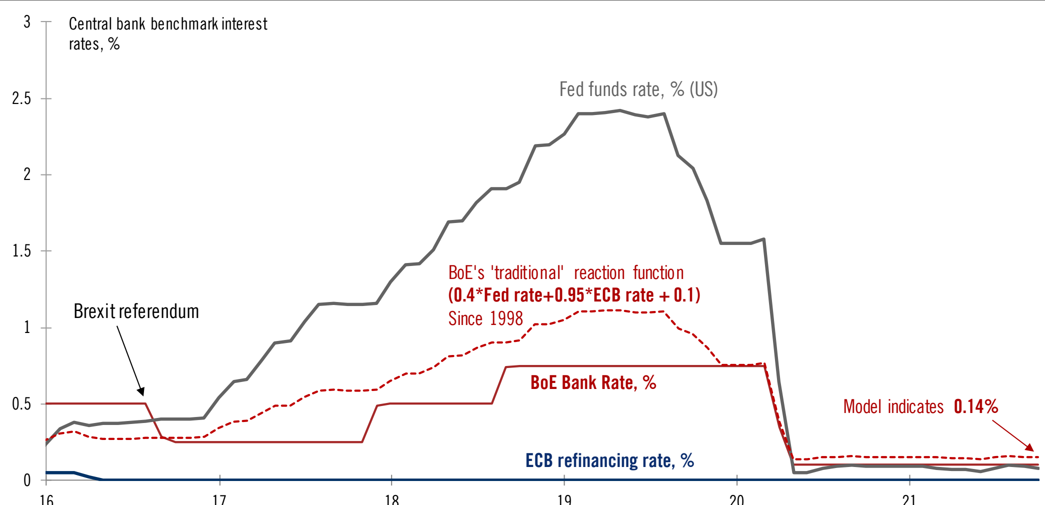
On top of the monetary tightening ahead, **several other threats are hanging over the UK economy**, including an increasingly fraught trade relationship with the EU. The status of Northern Ireland trade post Brexit has been a constant source of irritation, with a growing possibility that trade tensions escalate further in the coming weeks (if not days).

Another **downside risk to UK growth is the direction of fiscal policy**. In 2021, the government announced first a rise in corporate taxes and then a rise in national insurance and dividend taxes, even though government borrowing costs are still cheap and the UK's finances are in no worse a state than elsewhere. **The danger is that rising taxes hurt business sentiment.**

As a result of all these economic forces, and their likely impact on UK consumers, we are growing more sceptical about the UK's growth outlook, especially in 2022. Our GDP forecast for 2022 is 5.0%, but the **risks are clearly pointed downwards**.

Our current forecast for UK consumer price inflation is 2.7% in 2022, but **under review for a potential upward revision**. Failing to see how a genuine wage-price spiral could be triggered, we continue to see rise in **UK inflation as temporary** – although we reckon that trade frictions could mean it remains enduringly higher than in the EU or US.

CHART 3: THE BANK OF ENGLAND IS DIVERGING FROM OUR MACRO MODEL



Source: Pictet WM - AA&MR, Bloomberg, as of 12 October 2021.

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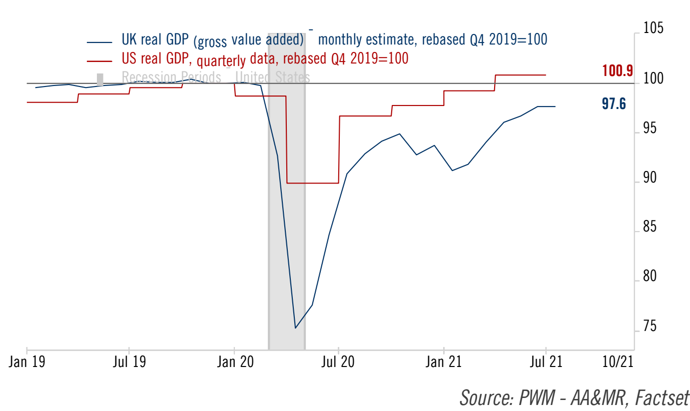
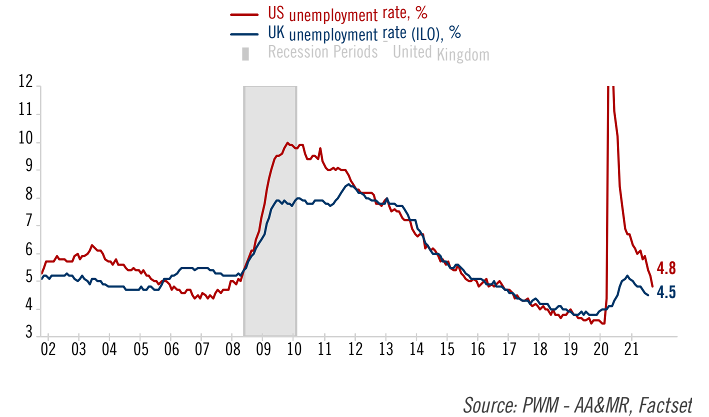
Charts: UK vs. US macro

US V. UK: GDP GROWTH, % Y-O-Y



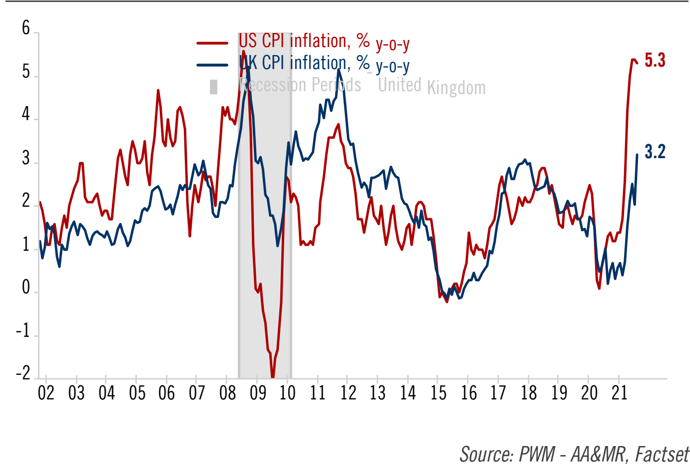
Source: PWM - AA&MR, Factset

US V. UK: UNEMPLOYMENT RATE, %



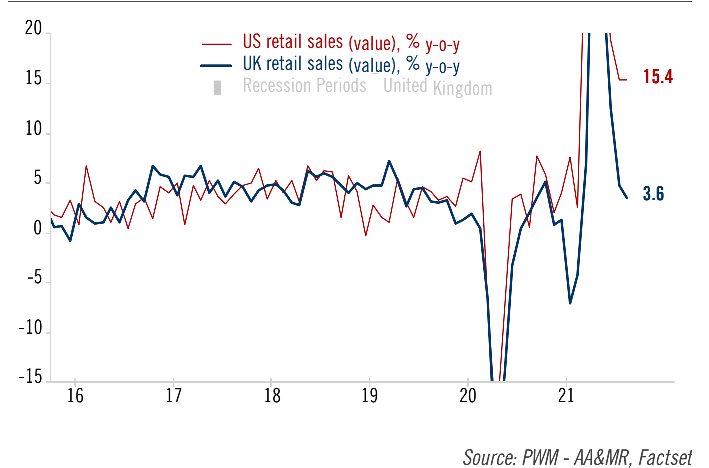
Source: PWM - AA&MR, Factset

US V. UK: CPI INFLATION, % Y-O-Y



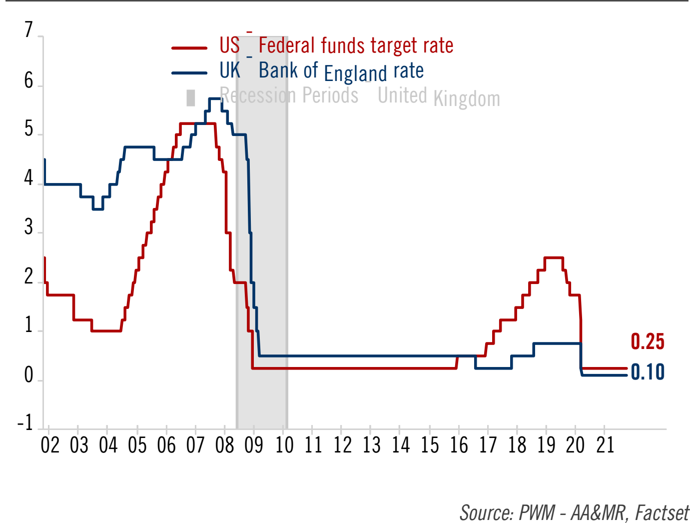
Source: PWM - AA&MR, Factset

US V. UK: RETAIL SALES, % Y-O-Y



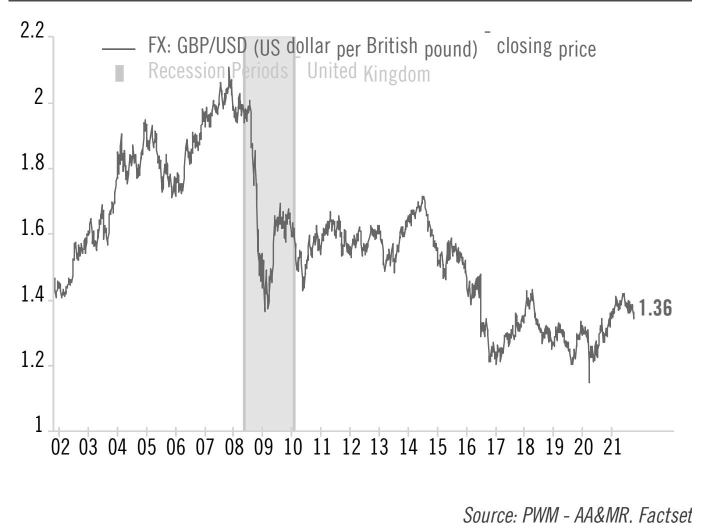
Source: PWM - AA&MR, Factset

US V. UK: BENCHMARK CENTRAL BANK RATE, %



Source: PWM - AA&MR, Factset

US V. UK: EXCHANGE RATE GBP/USD



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