

Detailed Economic Commentary on Developments during Q2 2022/23

The second quarter of 2022/23 saw:

- GDP in Q1 2022/23 revised upwards to 0.2% q/q from -0.1%, which means the UK economy has avoided recession for the time being;
 - Signs of economic activity losing momentum as production fell due to rising energy prices;
 - CPI inflation ease to 9.9% y/y in August but domestic price pressures showing little sign of abating in the near-term;
 - The unemployment rate fell to a 48-year low of 3.6% due to a large shortfall in labour supply;
 - Bank Rate rise by 100bps over the quarter, taking Bank Rate to 2.25% with further rises to come;
 - Gilt yields surge and sterling fall following the “fiscal event” of the new Prime Minister and Chancellor on 23rd September.
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- The UK economy grew by 0.2% in July following an upward revision to Q1’s GDP data (+0.2% q/q), though revisions to historic data left it below pre-pandemic levels.
 - There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% m/m) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Although some of this was probably due to the heat wave at the time, manufacturing output fell in some of the most energy intensive sectors (e.g., chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.
 - The fall in the composite PMI from 49.6 in August to a 20-month low of 48.4 in September points to a fall in GDP of around 0.2% q/q in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. That left sales volumes in August just 0.5% above their pre-Covid level and 3.3% below their level at the start of the year. There are also signs that households are spending their excess savings in response to high prices. Indeed, cash in households’ bank accounts rose by £3.2bn in August, which was below the £3.9bn rise in July and much smaller than the 2019 average monthly rise of £4.6bn.
 - The labour market remained exceptionally tight. Data for July and August provided further evidence that the weaker economy is leading to a cooling in labour demand. Labour Force Survey (LFS) employment rose by 40,000 in the three months to July (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July itself and there are now 904,000 more inactive people aged 16+ compared to before the pandemic in February 2020. The number of vacancies has started to level off from recent record highs but there have been

few signs of a slowing in the upward momentum on wage growth. Indeed, in July, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.

- CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below \$90pb, we would expect to see fuel prices fall further in the coming months.
- However, utility price inflation is expected to add 0.7ppts to CPI inflation in October when the Ofgem unit price cap increases, typically, to £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices at that level for two years, energy price inflation will fall sharply after October and have a big downward influence on CPI inflation.
- Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.
- The new Prime Minister and Chancellor have appeared to make a step change in government policy. The government's huge fiscal loosening from its significant tax cuts will add to these domestic inflationary pressures and will leave a legacy of higher interest rates and public debt. Whilst the government's utility price freeze, which could cost up to £150bn (5.7% of GDP) over 2 years, will reduce peak inflation from 14.5% in January next year to 10.4% in November this year, the long list of tax measures announced at the "fiscal event" adds up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. These included the reversal of April's national insurance tax on 6th November, the cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, the cut to stamp duty and the removal of the 45p tax rate, although the 45p tax rate cut announcement has already been reversed.
- Fears that the government has no fiscal anchor on the back of these announcements has meant that the pound has weakened, adding further upward pressure to interest rates. Whilst the pound fell to a record low of \$1.035 on the Monday following the government's "fiscal event", it has since recovered to around \$1.12. That is due to hopes that the Bank of England will deliver a very big rise in interest rates at the policy meeting on 3rd November and the government will lay out a credible medium-term plan in the fiscal statement on 23rd November. Nevertheless, with concerns over a global recession growing, there are downside risks to the pound.
- Since the fiscal event, we now expect the Monetary Policy Committee (MPC) to increase interest rates further and faster, from 2.25% currently to a peak of 5.00% in February 2023 (up from our previous forecast peak of 2.75%). The combination of the government's fiscal loosening, the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by 100bps at the policy meetings in November (to 3.25%) and 75 basis points in December (to 4%) followed by further 50 basis point hikes in February and March (to 5.00%). Market expectations for what the MPC will do are volatile. If Bank Rate climbs to these levels the housing market looks very vulnerable, which is one reason

why the peak in our forecast is lower than the peak of 5.50% priced into the financial markets at present.

- Gilt yields rose sharply at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank is restarting QE, although for financial stability reasons rather than monetary policy reasons.
- Since the Bank's announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.
- There is a possibility that the Bank continues with QE at the long-end beyond 14th October or it decides to delay quantitative tightening beyond 31st October, even as it raises interest rates. So far at least, investors seem to have taken the Bank at its word that this is not a change in the direction of monetary policy nor a step towards monetary financing of the government's deficit. But instead, that it is a temporary intervention with financial stability in mind.
- The S&P 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as concerns over economic growth leading to a deterioration in investor risk appetite.

MPC meetings 4th August and 22nd September 2022

In August, the Bank of England's Monetary Policy Committee (MPC) increased Bank Rate to 1.75%, and on 22nd September moved rates up a further 50 basis points to 2.25%. The increase reflected a split vote – five members voting for a 50 basis points increase, three for 75 basis points and one for 25 basis points. The MPC continues to grapple with getting inflation back on track over a three-year horizon.

- Moreover, the UK now has a new Prime Minister, a new Chancellor and new economic policies that seek to grow the UK economy faster than at any time since the 1980s. The central planks to the government's new policies are tax cuts and regulatory simplification. It is too early to say whether such policies will boost growth in the ways intended, but what is clear at this juncture is that the lack of scrutiny of the various projections, ideally by the Office of Budget Responsibility (OBR), and an emphasis upon borrowing to fund the significant cost of the proposals scared the markets.
- Subsequently, the Government has announced that the OBR will scrutinise their spending plans on 23rd November, after the MPC next meets on 3rd November. Naturally, the Bank Rate forecast set out below will be dependent on a more joined-up set of communications from the Bank of England and the government than that which we have seen or heard so far. In addition, the fiscal governance aspects referred to in the OBR's upcoming review in November will need to be suitably couched in reassuring language and analysis to persuade the markets that fiscal rectitude has not been abandoned.
- Of course, what happens outside of the UK is also critical to movement in gilt yields. The US FOMC has led with increases of 300 basis points in the year to date and is expected to increase rates further before the end of the year. 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. 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.