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UK - MACRO AND RATES SCENARIO 2022

OBSTACLES IN THE WAY OF A MORE ROBUST RECOVERY

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SUMMARY

- Our UK growth forecast for 2022 is on the cautious side, as various obstacles stand in the way of more robust recovery, including the lingering impact of Brexit. We predict 4.5% GDP growth in 2022, below the Bloomberg consensus of 4.9%.
- We forecast average CPI inflation of 3.9% in 2022, versus the Bloomberg consensus of 3.7%.
- Like most other countries, the UK's growth outlook will be mostly dictated by what happens to the 'excess' household and corporate savings built up during the covid-19 shock at a time of gradual fiscal and monetary retrenchment.
- Regarding Brexit, the risk is that the UK's relationship with the EU continues to deteriorate, especially over the trade status of Northern Ireland.
- As electricity and fuel prices spiral upwards, the management of the energy transition is another worry, eating into household purchasing power and impacting confidence.
- A sharp deterioration on the virus front is also a risk. While vaccination rates are high, the UK has chosen a more liberal approach to tackling new waves of the coronavirus than other European countries.
- Longer term, the rise in corporate taxes raises question marks over the country's friendliness to business, especially if they are the start of a trend.
- We expect one technical rate hike of 15bps from the Bank of England (BoE), either this month or in early 2022, followed by two 25bp rate hikes over the course of 2022. But the BoE's communication has been rather ambivalent lately. The Bank's traditional reaction function suggests it should hike after the Federal Reserve (which we see hiking in June). But the recent anxiety the BoE has been showing about rising inflation expectations leading to second-round effects means we expect it to move before the Fed.
- UK gilts yields rose strongly across maturities in October on the back of more hawkish comments from the BoE, which compelled market participants to bring forward their expectations for rate hikes. Since then, yields have declined again, due to falling inflation-linked (real) yields due to concerns for economic growth.
- We expect the 10-year gilt yield to move up again next year, partly in sympathy with US and German government bond yields, partly because the ongoing growth recovery and gradual BoE rate hikes will push real (inflation-linked) yields up (and prices down). Our central scenario (65% probability), is that the 10-year nominal gilt yield will reach 1.3% at end-2022 (up from 0.73% on 7 December 2021). Since higher yields will likely lead to negative total returns, we remain underweight on UK government bonds.

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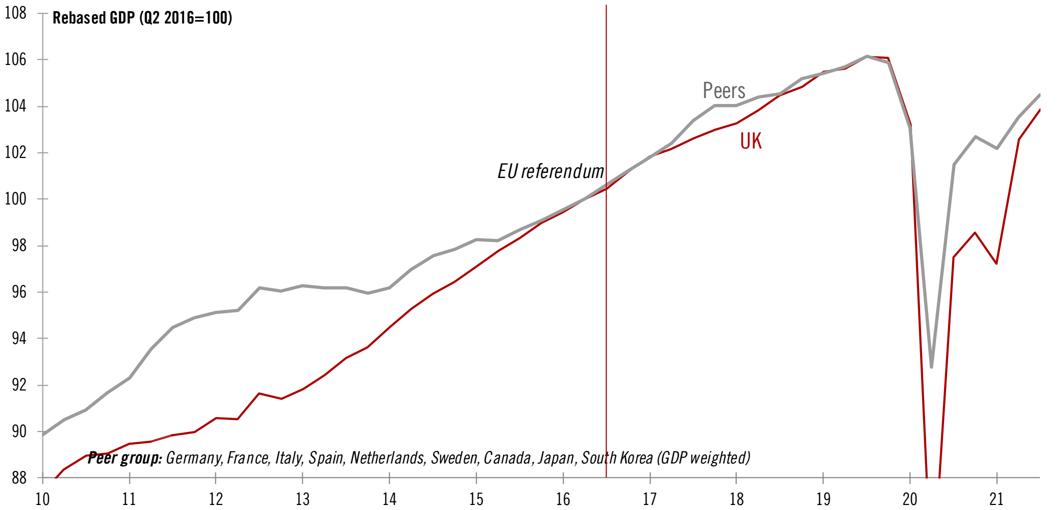
Mobilising savings to keep consumption going

As elsewhere in developed economies, the 2022 macro outlook for the UK will be mostly driven by a combination of the following four factors:

- Covid-19 and the government's health policy response
- The fiscal impulse
- Monetary and credit conditions
- The mobilisation of past savings.

Like most other countries, the UK government has started to turn off the tap on covid-19 fiscal support, with its jobs furlough scheme, ending in September. The macro focus instead is now turning to **mobilising the savings built up by households during the pandemic**. One proxy for these is 'excess bank deposits', (the above-trend rise in bank deposits since the pandemic first broke out), which, according to our calculations, total GBP152 bn, or about 6.6% of GDP. Our central scenario is that the gradual spending of these household savings will help to counter fiscal retrenchment in 2022.

CHART 1: THE UK'S RECOVERY HAS LAGGED BEHIND THAT OF ITS PEERS



Source: Pictet WM - AA&MR, Bloomberg, 7 December 2021.

An energy crisis is threatening the growth rebound

A number of issues peculiar to the UK explain our relatively cautious outlook on the country's prospects. In particular, the UK's exit from the EU and its ongoing fraught relationship with the latter remain a net negative for the UK economy. UK export activity is especially weak, which contrasts with the vigorous acceleration in global trade in 2021. Despite politicians' promises, the UK has not managed to speed up negotiations on a trade deal with the US. The complicated question of Northern Ireland is a massive obstacle to further rapprochement with the US (it is noticeable that the Biden administration has maintained Trump's tariffs on UK steel imports but removed them from EU imports).

There is a risk that the UK's **relationship with the EU sours further in 2022** as the UK has threatened to withdraw from the agreement on Northern Ireland's customs status (the so-

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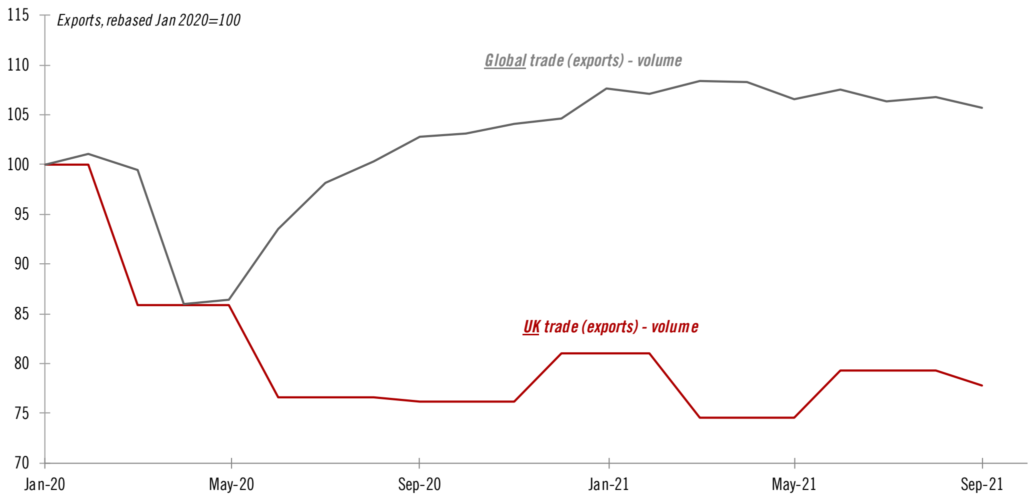
called 'Northern Ireland protocol'). This could prompt the EU into trade retaliation. The UK's relationship with France is especially fraught, most lately due to issues such as illegal migration and fishing quotas. Bottom line, **ongoing trade uncertainty is not good for UK business sentiment.**

Spiralling energy costs, which could sap household consumption and hit corporate margins, are another risk hanging over the UK economy. Baseload wholesale electricity prices averaged GBP42/MWh in 2019 but GBP174/MWh since August 2021. While the need to stem spiralling energy costs in the very short term is taking precedence over the UK government's attempt to position the country as a pioneer in wind energy generation, this winter could be particularly painful if temperatures fall below normal.

CHART 2: THE UK'S DISMAL EXPORT RECORD SINCE COVID



Source: Pictet WM - AA&MR, Bloomberg, as of 7 December 2021.

Like for most other developed economies, the impact of covid-19 constitutes a downside risk to our central scenario. The UK government has *de-facto* decided that society will have to live **with, or co-exist with, the virus**, leading it to adopt a relatively liberal attitude to the appearance of new variants and limited restrictions on social activity. To be sure, this approach is helped by high vaccination rates and a push to provide all adults with a third vaccine dose by end-January. Recently, while infections have been increasing, death rates related to the coronavirus remain low. Questions still unanswered at time of writing include whether the Omicron variant (or others) will jeopardise the government's approach and whether new virus strains will hurt consumer confidence and spending.

A more upbeat alternative to our central scenario would involve UK households spending accumulated savings more quickly than we expect and banks easing their credit conditions, thus offsetting monetary tightening.

In the longer run, it will be worth monitoring how 'business friendly' the UK government remains. The government of Boris Johnson recently raised corporate taxation (the base rate will increase by 6 points to 25% from April 2023). While the government claims this is a one-off aimed at plugging the budget deficit, the reality could prove different, depending on economic conditions. **A trend towards higher taxation would**

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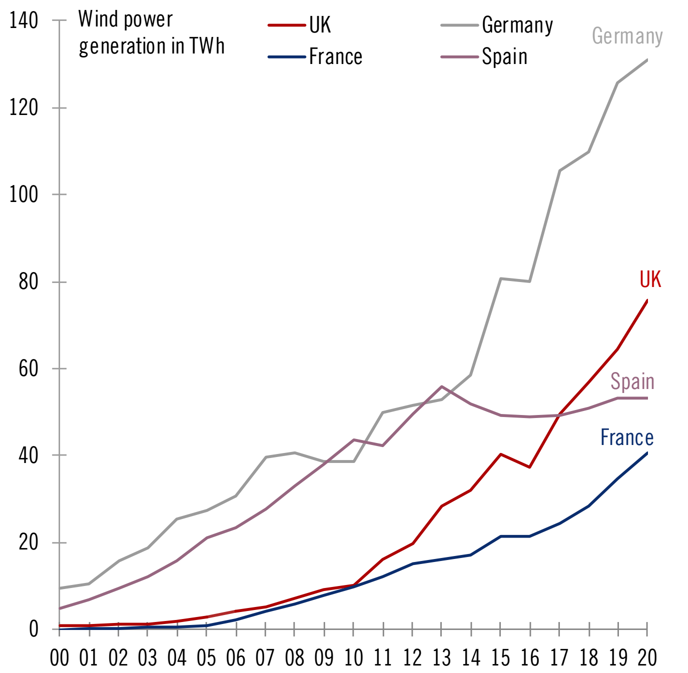
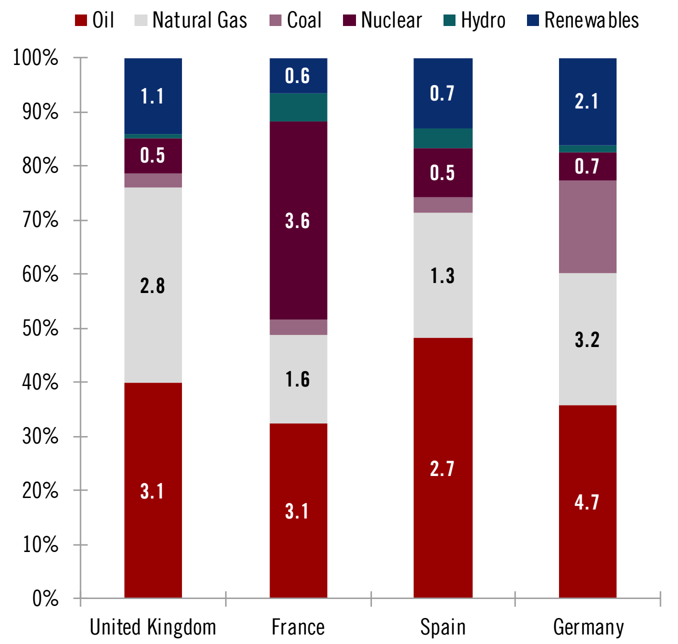
undoubtedly hurt business sentiment. It will also be important to watch how the government intends to deal with ongoing labour shortages in some sectors – inability of finding workers is an additional cost to businesses.

GRAPH 3: WIND POWER GENERATION IN TWH: UK VS. CONTINENTAL PEERS



Source: PWM - AA&MR, BP Statistical Review (July 2021)

GRAPH 4: SHARE OF PRIMARY ENERGY CONSUMPTION IN 2019 (%)



Numbers are consumption in exajoules (2019)

Source: PWM - AA&MR, BP Statistical Review (July 2021)

Meanwhile, the UK economy faces the same inflation challenges as its peers. These stem from persistent **global supply bottlenecks** (although there are tentative signs these are gradually easing) and the transmission of high commodity prices into core inflation. Brexit-related issues, such as the dire shortage of truck drivers have been adding to price pressure in the UK. We expect inflation to stay high, averaging 3.9% in 2022. Nevertheless, given the likely easing of logjams and some commodity prices, inflation could fall in the second half of the year.

Bank of England: Communication has been erratic, but rate hikes are coming

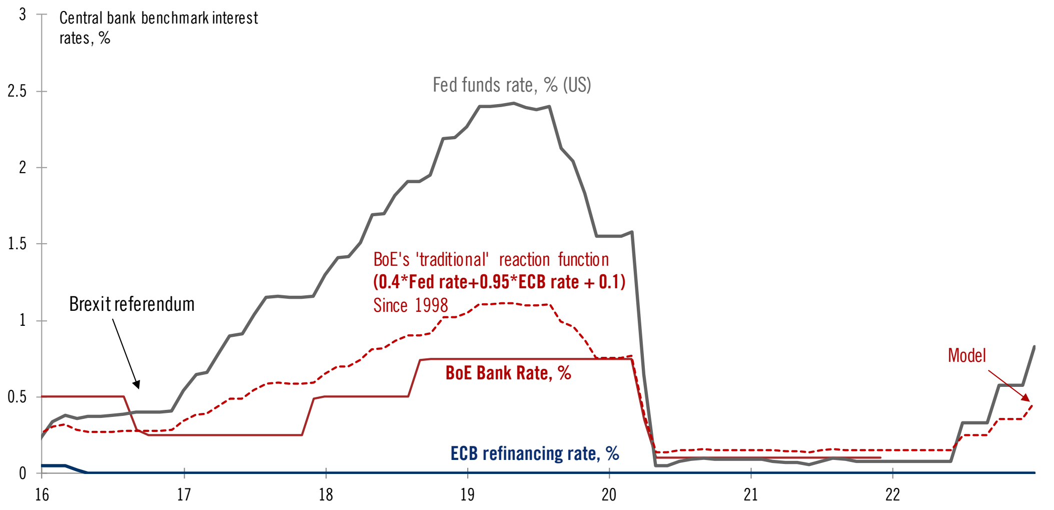
We **expect the BoE's Bank Rate (its main policy rate) to be 0.75% by year-end 2022, compared with today's 0.1%**. Recent communication from the bank raises doubts about predictions that the BoE's Monetary Policy Committee (MPC) will vote for a 15bps hike this month, which had been our central scenario up to now. There is a possibility that this technical hike is postponed to early 2022.

Before Omicron appeared, the Bank of England had been highlighting the risk posed by rising **inflation expectations, which it feared could** trigger second-round effects. Interestingly, the BoE's worries on this score seem to be abating, even as they are increasing among Federal Reserve officials. The Bank of England's governor Andrew Bailey said after the last MPC meeting in November that a rate hike had been a "close call", even though figures showed that a strong majority of the MPC had been in favour of keeping rates on hold (7-2). The Bank is expected to end its bond purchases at end-December 2021, as planned.

While the BoE might be moving ahead of the Fed, historical analysis of the correlation between Fed, European Central Bank (ECB) and BoE rate hikes – our theoretical BoE model – points to a Bank Rate of 0.46% at end-2022.

Our central scenario that the Bank Rate will be higher (0.75%) stems from a combination of historical modelling and analysis of recent BoE communication. However, if the BoE's concerns about the downside risks to growth prevail over inflation worries, then the BoE could raise rates less than our central scenario assumes.

CHART 3: CONTRARY TO OUR MODEL, THE BANK OF ENGLAND COULD HIKE RATES BEFORE THE FED



Source: Pictet WM - AA&MR, Bloomberg, as of 5 December 2021.

UK sovereign yields should move higher

UK gilts yields moved higher across maturities in October on the back of hawkish comments from the BoE, which compelled market participants to bring forward their rate-hike expectations. The 10-year gilt yield reached a high of 1.21% and the 2-year yield 0.66% on 21 October. Due to falling real yields, **gilt yields have dropped since then**, standing at 0.73% and 0.39%, respectively, on 7 December (*see chart 4*).

In turn, the slide in inflation-linked yields is due to concerns for economic growth stemming from the appearance of new strains of the coronavirus, enduring supply-side bottlenecks and rocketing energy prices. These factors have also led **market participants to revise down their expectations for BoE rate hikes**. On 7 December, they were pricing in a small, 7bp hike at the BoE's monetary policy meeting a week later and then an additional 100 bps (four 25bp hikes) in 2022, a pricing that it is more hawkish than our UK economist's forecast of two hikes next year.

Market-based inflation expectations remain elevated in the UK, with the 10-year inflation breakeven rate hovering around 4.2% despite the drop in the oil price from a peak of USD86 per barrel on 26 October to USD75 on 7 December (*see chart 5*). We **attribute high inflation expectations both to the spike in energy** (especially natural gas)

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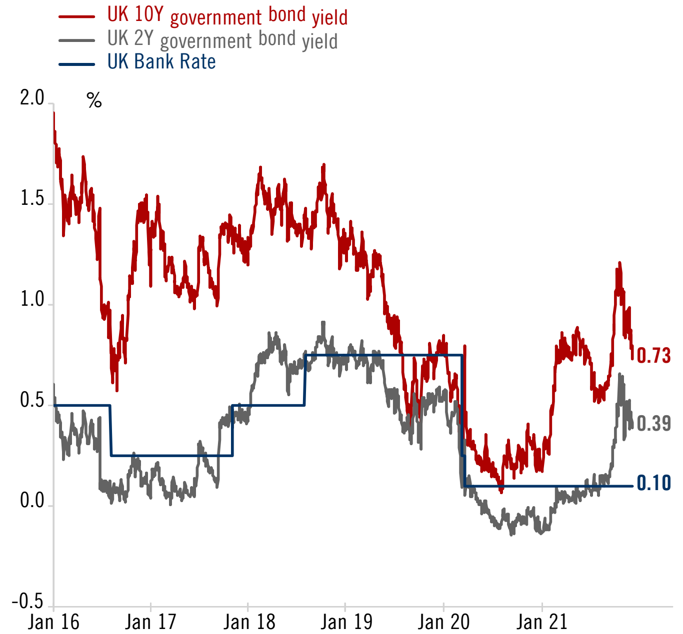
prices in the UK and to signs of cold feet at the BoE about raising rates in the short term. As mentioned in our previous note (see Inflation expectations are challenging the Bank of England), we expect the BoE to partially succeed in dampening inflation expectations if it tightens its monetary policy stance as we expect, with a first 15 bps hike this December.

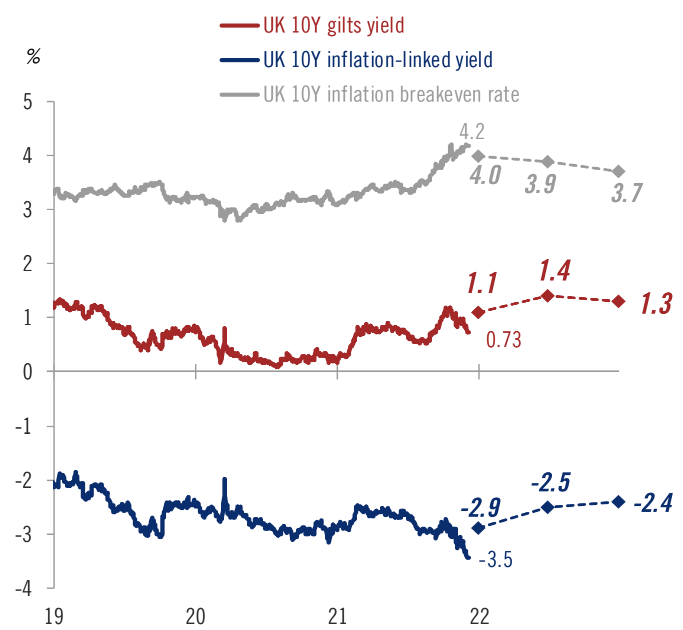
While our UK economist expects headline CPI to remain elevated next year on average, **it is likely to dip in the second half of the year**. This, coupled with our expectation for **a Bank Rate at 0.75% at the end of 2022, should push down market-based inflation expectations**. Hence, we expect the 10-year inflation breakeven rate to end next year at 3.7%.

CHART 4: UK TWO AND 10-YEAR GILT YIELDS AND POLICY RATE



Source: PWM - AA&MR, Factset, 07.12.2021

CHART 5: UK 10-YEAR GILT YIELD AND FORECASTS



Source: PWM - AA&MR, Bloomberg, 07.12.2021

The policy rate path we expect the BoE to follow should lead to renewed steepening of the UK sovereign yield curve after its recent flattening, with the slope between 10 and two-year yields falling to 28 bps on 7 December (*see chart 6*). In fact, **a more dovish BoE than is currently being priced in by market participants should limit the risk of a policy error and preserve growth momentum despite looming threats** (the energy crisis, the Omicron variant and the troublesome EU-UK trade relationship). For these reasons, in concert with US and German sovereign yields, we expect UK real yields to climb again, as they usually do when economic growth is resilient and the BoE hikes rates.

However, **persistently higher inflation in the UK is likely to sustain strong investor demand for inflation-hedged assets**. For this reason, we expect the rise in inflation-linked yields to be gradual, with the 10-year inflation-linked yield remaining sharply negative (at -2.4% compared with -3.5% on 7 December, *see chart 5*).

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Given that purchasing power is a major political issue, a drop in inflation will be greeted with relief by the government of Boris Johnson. **The drop in inflation will also be good for public finances, since inflation-linked bonds constitute an unusually large share (23%) of total UK government bonds outstanding** (*see chart 7*). In fact, rising inflation is making it more costly to service inflation-linked bonds and could cancel to some extent the positive effect of low nominal bond yields on government finances.

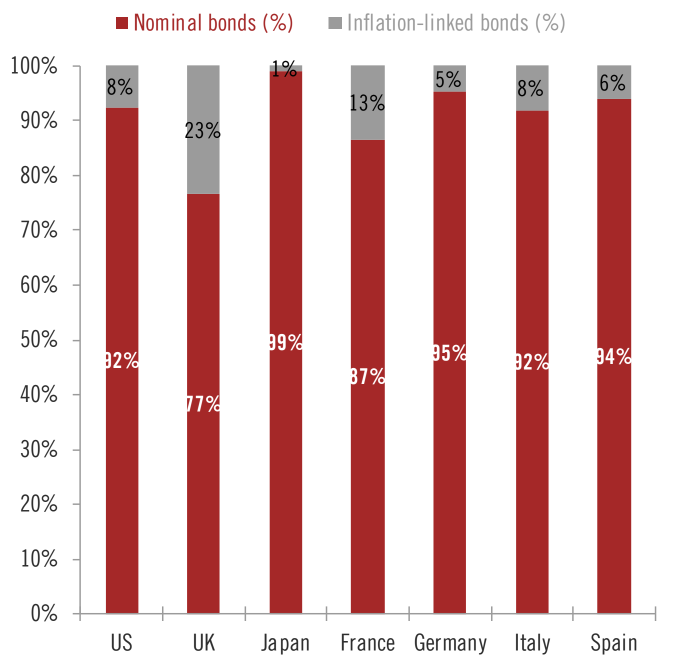
All in all, we expect the 10-year gilt yield to move up again next year, partly in sympathy with US and German government bond yields (see Room for yields to rise again), partly because the ongoing growth recovery and gradual BoE rate hikes will push real yields up (and prices down). Our central scenario (65% probability) **is for a nominal 10-year gilt yield of 1.3% at end-2022** (up from 0.73% on 7 December). With higher yields likely to lead to negative total returns, **we are maintaining our underweight stance on UK government bonds.**

There are upside and downside risks to this central scenario. In our **downside scenario** (to which we assign a 25% probability), we see the Omicron variant and/or the risk of a policy error by the BoE hitting the UK's economic recovery, leading to an inversion of the 10-to-two year part of the yield curve and a **10-year gilt yield that stays below 1%.** In our **upside scenario** (10% probability), more robust economic growth in the UK, along with a more patient BoE could lead to sharper yield-curve steepening, with **the 10-year gilt yield ending next year at around 1.6%.**

CHART 6: UK AND US 10-TO-TWO-YEAR YIELD CURVE SLOPE

Source: PWM - AA&MR Factset, 07.12.2021

CHART 7: SOVEREIGN BONDS' SHARE OF INFLATION-LINKED BONDS



Source: PWM - AA&MR, Bloomberg, 12.11.2021

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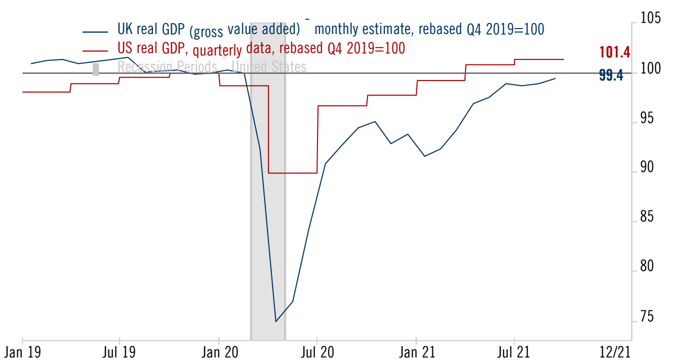
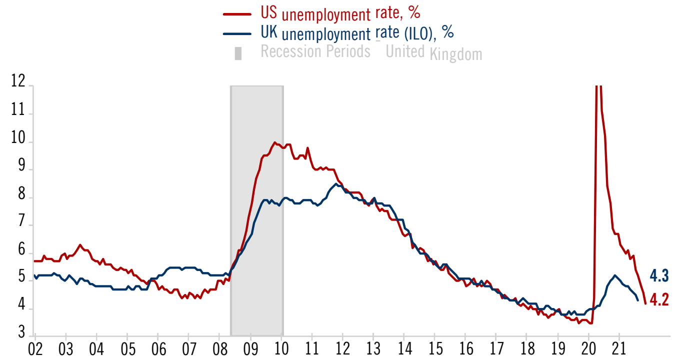
Charts: UK vs. US macro

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



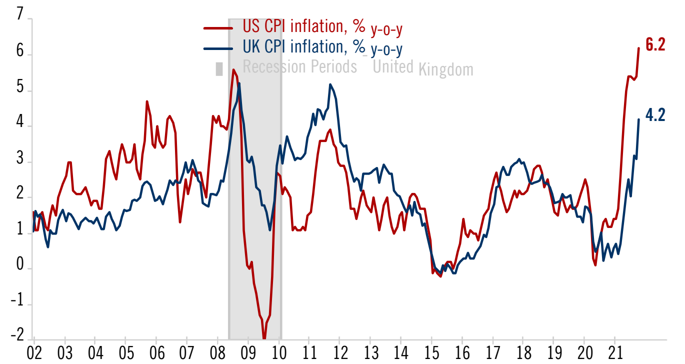
Source: PWM - AA&MR, Factset

US V. UK: UNEMPLOYMENT RATE, %



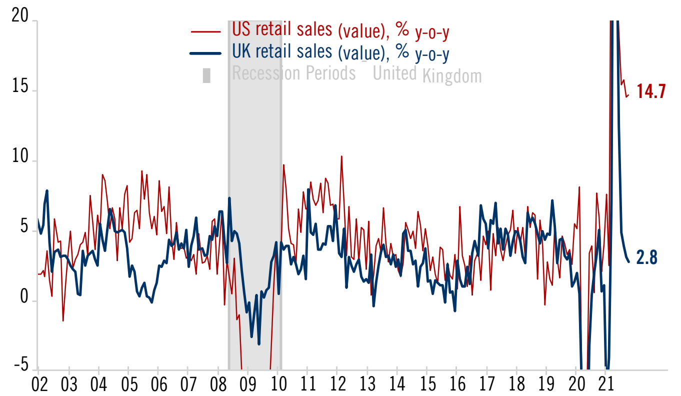
Source: PWM - AA&MR, Factset

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



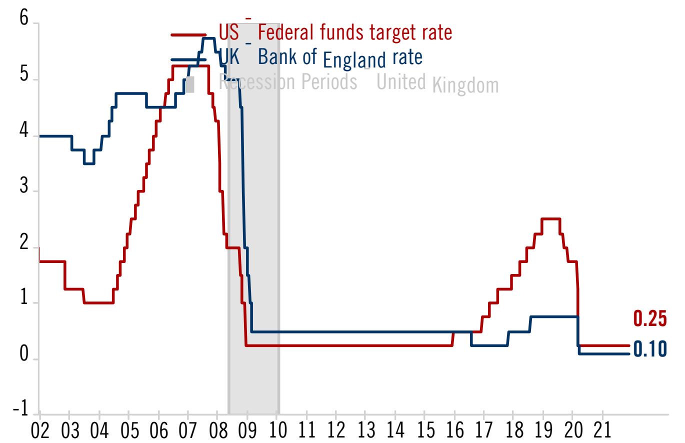
Source: PWM - AA&MR, Factset

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



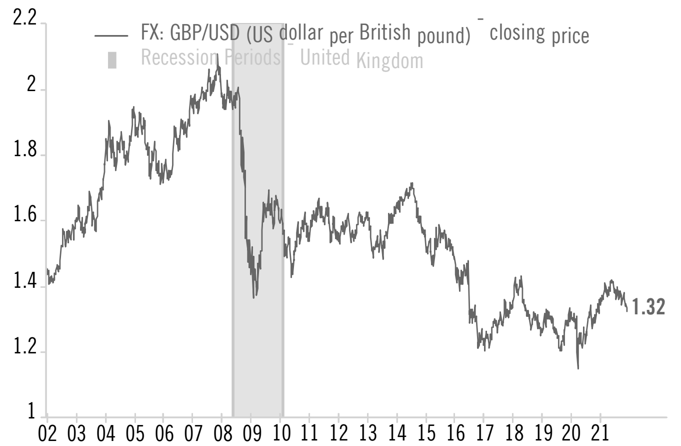
Source: PWM - AA&MR, Factset

US V. UK: BENCHMARK CENTRAL BANK RATE, %



Source: PWM - AA&MR, Factset

US V. UK: EXCHANGE RATE GBP/USD



Source: PWM - AA&MR, Factset

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