Pulse

By Mabrouk Chetouane & Nicolas Malagardis - Global Market Strategy, NIM Solutions October, 2022

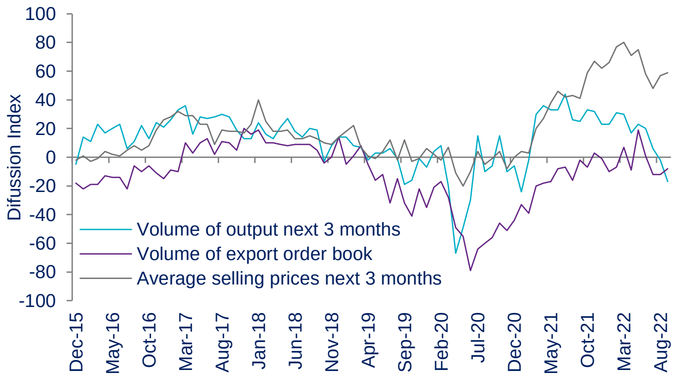
UK is in a tight spot

After a tumultuous month, Rishi Sunak has been appointed as UK's new prime minister bringing calm back to the UK markets for now. The 180-degree turn taken by Rishi Sunak on several topics (fracking, taxes and fiscal policy, etcetera…) has contributed to reduce the risk premium surge as reflected by the sharpest decline of the 2-year gilts yield in over 30 years and the strong rebound of the pound. However, while these developments are indeed encouraging since they have moved things on the right direction, the new prime minister still faces a sobering task. He needs to reassure markets that the country's public finances are back onto a sustainable path at a moment when the economy is deteriorating fast and needs support.

Cloudy skies ahead

Expectations were missed in October for both the services and manufacturing PMIs, which are now indicating contractionary dynamics, and stand at 47.5 and 45.8, respectively. Industrial surveys do not paint a rosier future for at least the next three months either as output is expected to fall further while prices remain elevated (see Chart 1). As a matter of fact, UK's inflation rose to 10.1% year-over-year in September with both the services and goods components accelerating on a monthly basis and with the energy component still advancing 49.6% year-over-year. It should be noted that while goods' inflation has started to come off on most other developed countries as consumption shifts from goods into services, UK's stance as a large net importer of both energy and non-energy goods is preventing this side of inflation from easing and offsetting services' price pressures.

Chart 1: UK Industrial Surveys (Sources: Bloomberg and NIM Solutions)



This persistent inflationary backdrop, coupled with a very tight job market, which continues to fail to bring people back into the labor force, is pushing salaries up, especially those in in the services sector, which usually entail higher risks of triggering second round effects, i.e., price-wage loop effect. On top of that, over 90% of mortgages are expected to reset their rates during the 5 years, adding another layer of cost pressure to households as standard variable mortgage rates have soared 40% since the start of the year and now trade above 5%.

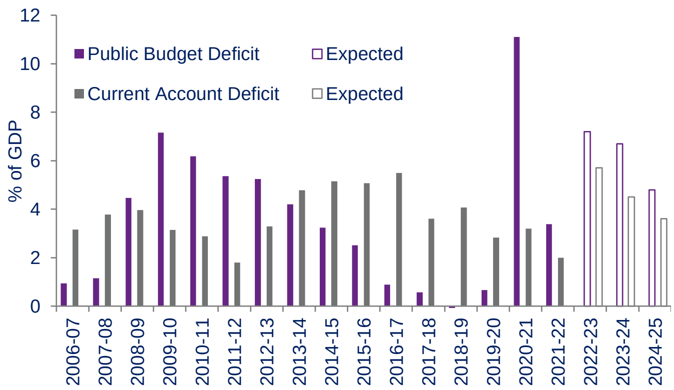
Against this delicate context, the BoE and the Treasury need to implement coordinated policies to minimize the economic pain and maintain credibility, especially when fiscal support will indeed be necessary. A recession next year, however, can no longer be avoided; our central scenario sees the UK's GDP contracting by 0.6% in 2023.

Policy coordination; easier said than done

The recovery of the pound and the decline in borrowing costs witnessed in the last weeks have certainly reduced the extent of the fiscal challenge that the new government faces. Indeed, markets have welcomed the backtracking of most of the "mini-budget" fiscal measures as the Treasury's expected debt issuance has fallen considerably.

However, the UK's structural current account deficit, which results from high imports of goods relative to its exports of services, implies that external funding needs will remain high. Even as the government moves towards spending cuts, the recession and purchasing power demands are likely to lead to higher deficits. The combination of external and internal financing needs (twin deficits) could support further increase in long term rates and could weak also the already undermined pound. In addition, since the Office of Budget Responsibility (OBR) last March already expected the government's budget deficit to remain elevated during the next couple of years, investors will require further reassurance that debt gets back on track to a sustainable path (see Chart 2). Reports suggest that the Chancellor of the Exchequer Jeremy Hunt needs to fill a fiscal shortfall of about GBP 30 to 50 billion by the fiscal statement scheduled for mid-November. Particular attention will be given to the prospects of the fiscally expensive Energy Price Guarantee program which was meant to last two years but is now expected to end in April 2023.

Chart 2: UK's Twin Deficits (Sources: Bloomberg and NIM Solutions)



Moreover, the delay of the fiscal statement means that OBR will have the opportunity to incorporate the improvement in borrowing costs when assessing the viability of the new fiscal plan. The delay also means that the next policy meeting of the BoE will now be taking place without the Monetary Policy Committee knowing the full details of the plan. However, we expect the dialogue between the Treasury and the BoE to be restored and, therefore, the committee to be aware that material fiscal consolidation is coming – even if it cannot account for it on its November forecast.

All in all, given the rapidly deteriorating economic backdrop, it will become increasingly less necessary –and costly– for the BoE to deliver big rate hikes. Thus, although a 75bp hike at the next two policy meetings remains our base case, we do see the second one becoming less likely and tilted towards a smaller one. The likelihood of this scenario would increase if markets were to react on a positive way to the fiscal consolidation plan. The BoE needs to carefully time the slowing economic cycle, the lagging effect of its monetary policy as well as that of the new fiscal plan.

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