PICTET WEALTH MANAGEMENT

UK macro and rates 2023 outlook

The need to restore trust

AUTHORS
LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com
THOMAS COSTERG, CFA
tcosterg@pictet.com

19 DECEMBER 2022, CIO OFFICE & MACRO RESEARCH

FLASH NOTE

SUMMARY

- The UK economy is facing a range of challenges, from structural issues to the energy crisis. PM Rishi Sunak needs to restore trust in the outlook for UK public finances without asphyxiating the already-weak economy through an excessive tax burden. We forecast a 2023 GDP decline of 1.6%. We expect consumer price inflation of 6.0% in 2023.
- After hiking by 50bp to 3.5% at its December meeting, we expect the Bank of England to implement two more 50bp hikes before a final 25bp rate increase to 4.75% in May. But this could depend on the severity of the recession in the first half of the year and whether the Federal Reserve hikes again in March. As of 19 December, market participants were pricing in a bank rate of 4.63% by June.
- Even though in October many market participants (us included) feared that the UK government bond market rout had an emerging-market flavour, the fall in yields and sterling's strengthening against the US dollar since then lead us to believe that the new government has already regained some of the credibility the UK lost around the time of the Truss mini-budget. Nevertheless, the Bank of England's resolve in its fight against inflation will also be crucial in avoiding another sharp rise in long-term gilt yields.
- We expect UK gilt yields to remain range bound between 3% and 3.8% next year, driven by still-elevated inflation and higher policy rates on the one hand and falling economic growth on the other. Forecasting the 10-year yield to end 2023 at 3.3%, we have recently moved from underweight to neutral on UK gilts.

STRUCTURAL CHALLENGES AND ERODED TRUST IN POLICYMAKING

The UK economy is facing a range of challenges, from structural issues (the most obvious of which is Brexit) to the energy crisis. On top of this, **investor confidence in UK policy took a big hit under the short-lived premiership of Liz Truss, resulting in additional interest-rate and risk premia for UK businesses and assets**.

Her successor, Rishi Sunak, faces a difficult task in trying to rebuild confidence. In particular, he has to restore trust in the outlook for UK public finances without asphyxiating the UK's already weak economy through an excessive tax burden.

From having forecast a sharp increase in net issuance of gilts under Liz Truss's premiership, on 17 November the UK Debt Management Office revised the UK government's net refinancing requirement for the current fiscal year 2022-23 down from GBP234.1 bn to GBP202.7 bn in the wake of the budget brought by the new Chancellor of the Exchequer, Jeremy Hunt. Although not particularly conservative, it still foresees more tax income (largely through tax-band freezes and windfall taxes on energy groups) and less fiscal spending (through reduced support for energy bills) than was planned in the 'mini budget' of his short-lived predecessor. **This will bring down the amount of net gilt issuance this fiscal year by GBP24.4 bn to GBP169.5 bn.**

UK consumers, whose real incomes have been hit by inflation, will soon also be faced with new tax hikes. Meanwhile, weak business confidence is likely to weigh on corporate investment plans. As a result, **we expect the UK economy to contract by 1.6% in 2023**, more than current Bloomberg consensus of -1.0%. Consumer price inflation fell slightly from 11.1% year-on-year in October to 10.7% in November. While the October reading may have represented the peak in inflation, we think the descent will be gradual due to resilient services prices as well as the renewed rise in utility bills in April 2023. **Our forecast is for a very gradual descent in headline consumer inflation to an average of 6.0% in 2023**.

A COMPLICATED TASK LIES AHEAD FOR THE BANK OF ENGLAND

As expected by market participants, the Bank of England (BoE) hiked the bank rate by 50bp to 3.5% at its December meeting. Six of the monetary committee's nine members voted for the 50 bp rise and one for a 75 bp rise, while two voted for the bank rate to remain unchanged. The tone of the BoE's statement was relatively hawkish in our opinion, stating that it believes that inflation risks are still skewed "to the upside" in particular due to high wage growth and a tight labour market. The BoE, echoing the Federal Reserve (Fed) in the US, highlighted the still-high vacancies-to-unemployment ratio. As such, **the Bank of England said a "forceful monetary policy response" is needed, while it warned that more tightening is to come.**

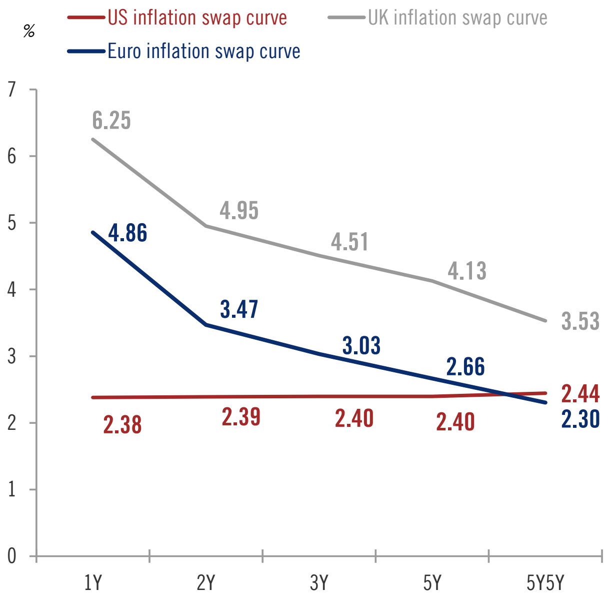
As of 19 December, market participants were pricing in a 44bp hike at the BoE's next meeting on 2 February. We expect a 50bp hike, followed by another 50bp hike in March. **We then expect a final 25bp hike to 4.75% in May, shortly after the further increase in energy bills due to take effect in April, because of the Bank's concerns about second-round inflation effects.** But the hiking trajectory could depend on the severity of the recession in the first half of the year (and whether the labour market weakens), and the size of a Fed rate increase in March. While **the Bank of England obviously responds to domestic conditions, we think it is also very influenced by policy-making in the euro area and in the US**. As of 19 December, market participants were pricing in a bank rate of 4.63% by June 2023.

For illustrative purposes. Past performance should not be taken as a guide to or guarantee of future performance. Performances and returns may increase or decrease as a result of currency fluctuations. There can be no assurance that these projections, forecasts or expected returns will be achieved. The projection is not based on simulated past performance.

Chart 1: UK policy rate and gilt yields

Source: Pictet Wealth Management, FactSet, 16 December 2022

Chart 2: US, UK and euro inflation swap curves



Source: Pictet Wealth Management, Bloomberg Finance L.P., 16 December 2022

INFLATION OUTLOOK WILL BE KEY FOR GILTS

Although the turbulence in the UK's leadership and budget has caused havoc in the gilt markets in recent months, yields have stabilised since Jeremy Hunt's fiscal statement on 17 November. After peaking at 4.47% on 10 October, the UK 10-year yield had fallen to 3.38% by 16 December, coming down 7bp in the wake of the Bank of England's December meeting alone (probably due to the bleak macroeconomic outlook outlined by the BoE, *see chart 1*).

Even though the amount of net gilt issuance the market will need to digest next year is still unprecedented, **the government's commitment to bring down the UK public debt-to-GDP ratio over the medium term seems to have reassured the market somewhat**. What's more, **UK inflation is showing signs of moderating**, and is likely to decelerate further next year given the ongoing economic slowdown. This has led sterling inflation swap curves to come down significantly, with one-year inflation expectations at 6.25% and 10-year expectations at 3.5% (on 16 December, *see chart 2*). While still well above the BoE's 2% target, this moderation has helped to drive gilt yields lower recently.

Another important contributor to their fall has been the sharp drop in inflation-linked bond yields, which had surged on the back of massive selling by UK liability-driven investment funds' in the wake of the ill-fated September "mini-budget". Although the BoE mini-quantitative easing quickly helped to restore some normality to the market, the 10-year inflation-linked government bond yield only fell back into negative territory in late October (after peaking at 1.23% on 10 October). It currently stands at -0.30% (on 19 December).

Even though in October many market participants (us included) saw hints of an emerging-market crisis in the UK government bond market rout, **the fall in yields**

For illustrative purposes. Past performance should not be taken as a guide to or guarantee of future performance. Performances and returns may increase or decrease as a result of currency fluctuations. There can be no assurance that these projections, forecasts or expected returns will be achieved. The projection is not based on simulated past performance.

and sterling's strengthening against the US dollar since then shows the new government has regained some of the UK's lost credibility. Nevertheless, the Bank of England's resolve in its **fight against inflation will also be also crucial in avoiding another sharp rise in long-term gilt yields.**

We expect UK gilt yields to remain range bound between 3% and 3.8% next year, driven by still-elevated inflation and higher policy rates on the one hand and falling economic growth on the other. **Forecasting the 10-year yield to end 2023 at 3.3%, we have recently moved from an underweight to neutral position on UK gilts.**

DISCLAIMERS

Distributors: Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland and Pictet & Cie (Europe) SA, 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687 L-2016 Luxembourg.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) SA is established in Luxembourg, authorized and regulated by the Luxembourg Financial Authority, Commission de Surveillance du Secteur Financier.

This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated.

Distributor: Pictet & Cie (Europe) S.A., London branch ("Pictet London Branch")

This is a marketing communication distributed by Pictet London Branch.

This document sets forth neither a personal recommendation tailored to the needs, objectives and financial situation of any individual or company (investment advice as defined in the Financial Conduct Authority's Handbook of rules and guidance (the "FCA Handbook")), nor the results of investment research within the meaning of the FCA Handbook. Moreover, it does not constitute an offer, or an invitation to buy, sell or subscribe to securities or other financial instruments, nor is it meant as a proposal for the conclusion of any type of agreement. Furthermore, this document should not be considered a suitability report as Pictet London Branch has not received all the necessary information on the recipient to complete its suitability assessment that covers the recipient's knowledge and experience, tolerance to risk, investment needs and the recipient's ability to absorb financial risk. Should its addressee decide to proceed to any transaction in relation to a financial product referred to herein, this will be in his sole responsibility, and the suitability/appropriateness of the transaction and other financial, legal and tax aspects should be assessed by an expert.

Any information contained in this document is disclosed for information purposes only, and neither the producer nor the distributor can be held liable for any fluctuation of the price of the securities. No express or implied warranty is given as to future performance. The opinions expressed reflect an objective evaluation of information available to the general public, such as rates from customary sources of financial information. The market value of securities mentioned may vary on the basis of economic, financial or political changes, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. It is also expressly noted that forecasts are not a reliable indicator of future performance, while past performance is not a reliable indicator of future results.

You shall only take investment decisions when you fully understand the relevant financial product and the involved risks. In particular, the relevant product documentation (such as the issuance program, final terms, prospectus, simplified prospectus and key (investor) information document), as well as Appendix 4: Risk Warnings Relating to Trading in Financial Instruments of the Terms and Conditions of Pictet London Branch, shall be read. Structured products are complex financial products and involve a high degree of risk. The value of structured products depends not only on the performance of the underlying asset(s), but also on the credit rating of the issuer. Furthermore, the investor is exposed to the risk of default of the issuer/guarantor.

In respect of any product documentation, including key information documents of Packaged Retail and Insurance-based Investment Products ("KIDs") and key investor information documents of Undertakings for Collective Investment in Transferable Securities ("KIIDs"), please note that these may change without notice. You should therefore ensure that you review the latest version of them prior to confirming to Pictet London your decision to invest. If you have been provided with a link to access the respective KID/KIID/other product document, you should therefore click on the link immediately before confirming to Pictet London Branch your decision to invest, in order to review the most recent version of the respective KID/KIID/other product document. If you have not been provided with a link to access the relevant document, or if you are in any doubt as to what the latest version of the respective KID/KIID/other product document is, or where it can be found, please ask your usual Pictet London Branch contact.

Pictet London Branch is not the manufacturer of the product(s) and the KID/KIID/other product document is provided by a third party. The KID/KIID/other product document is obtained from sources believed to be reliable. Pictet London Branch does not make any guarantee or warranty as to the correctness and accuracy of the data contained in the KID/KIID/other product document. Pictet London Branch may not be held liable for an investment decision or other transaction made based on reliance on, or use of, the data contained in the KID/KIID/other product document.

By subscribing to the product(s) proposed herein, you acknowledge that you have (i) received, in good time, read and understood any relevant documentation linked to the product(s), including, as the case may be, the respective KID/KIID/other product document; (ii) taken note of the product(s) restrictions; and (iii) meet the applicable subjective and objective eligibility conditions to invest in the product(s).

Pictet London Branch may, if necessary, rely on these acknowledgements and receive your orders, to transmit them to another professional, or to execute them, according to the relevant clauses of your mandate, as well as the Terms and Conditions of Pictet London Branch.

The content of this document shall only be read and/or used by its addressee. Any form of reproduction, copying, disclosure, modification and/or publication in any form or by any means whatsoever is not permitted without the prior written consent of Pictet London Branch and no liability whatsoever will be incurred by Pictet London Branch. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information provided in this document.

Pictet London Branch is a branch of Pictet & Cie (Europe) S.A.. Pictet & Cie (Europe) S.A. is a société anonyme (public limited liability company) incorporated in Luxembourg and registered with the Luxembourg Registre de Commerce et des Sociétés (RCS no. B32060). Its head office is at 15A, avenue J.F. Kennedy, L-2016 Luxembourg. Pictet London Branch is registered as a UK establishment with Companies House (establishment number BR016925) and its UK establishment office address is Stratton House 6th Floor, London, 5 Stratton Street, W1J 8LA.

Authorised and regulated by the Commission de Surveillance du Secteur Financier. Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

Distributors: Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore and/or Banque Pictet & Cie SA, Hong Kong Branch ("Pictet HK Branch") in Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document is intended for general circulation and it is not directed at any particular person. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK Branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor, and accepts no fiduciary duties to any investor in this regard, except as required by applicable laws and regulations. Furthermore, BPCAL/Pictet HK Branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK Branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK Branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK Branch to update any of them. BPCAL/Pictet HK Branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are from sources believed to be reliable, BPCAL/Pictet HK Branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK Branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK Branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK Branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK Branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document.

The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK Branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK Branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK Branch.

Singapore

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL is a wholesale bank regulated by the Monetary Authority of Singapore ("MAS") under the Banking Act Cap. 50 of Singapore, an exempt financial adviser under the Financial Advisers Act Cap. 110 of Singapore ("FAA") and an exempt capital markets licence holder under the SFA. Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

Hong Kong

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK Branch and any of its affiliates or related corporations to any prospectus or registration requirements. If you do not want Pictet HK Branch to use your personal information for marketing purposes, you can request Pictet HK Branch to stop doing so without incurring any charge to you. In distributing investment products as agents for third party service providers, Pictet HK Branch is an agent of the third party service provider and the product is a product of the third party service provider but not Pictet HK Branch. In respect of an eligible dispute (as defined in the Terms of Reference for the Financial Dispute Resolution Centre in relation to the Financial Dispute Resolution Scheme) arising between Pictet HK Branch and you out of the selling process or processing of the related transaction, Pictet HK Branch is required to enter into a Financial Dispute Resolution Scheme process with you; however any dispute over the contractual terms of the product should be resolved between directly the third party service provider and you.

Banque Pictet & Cie SA is a limited liability company incorporated in Switzerland. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: BMG891) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities. The registered address of Pictet HK Branch is 9/F., Chater House, 8 Connaught Road Central, Hong Kong.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK Branch in Hong Kong in respect of any matters arising from, or in connection with this document.

Distributor: Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence, The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined in the Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c); (ii) Arrange Deals in securities; (iii) Manage Securities; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.