PICTET WEALTH MANAGEMENT

UK macro and bonds update

Higher UK rates for longer to tackle inflation

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FLASH NOTE

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SUMMARY

- Inflation in the UK has been higher and more persistent than the Bank of England (BoE) expected. Following the large upside surprise in April core CPI, market participants expect inflation to remain around 4% for over the next five years, well above the BoE's 2% long-term target.
- As a result, the path for BoE rates has been repriced materially higher, with a peak rate close to 5.5%. The two-year UK gilt yield, which is more sensitive to monetary policy, has already moved up to 4.43%, while the 10-year yield was well above its US counterpart at 4.27% (on 30 May).
- Although current market pricing looks elevated to us given our forecast for an economic slowdown and lower headline inflation in H2, we expect that 10-year gilt yields could remain above 4% for some time. As such, we have revised our year-end forecast higher, from 3.3% to 4.0%.
- Finally, UK gilts have become increasingly attractive for foreign investors now that they offer the highest yields in the core sovereign bond space, even once hedging costs are taken into account. But for investors' confidence to be retained, both the BoE and the UK government need to stay the course in keeping the UK public debt trajectory on a sustainable path.

STICKY INFLATION STILL EXPECTED TO EASE IN H2 2023

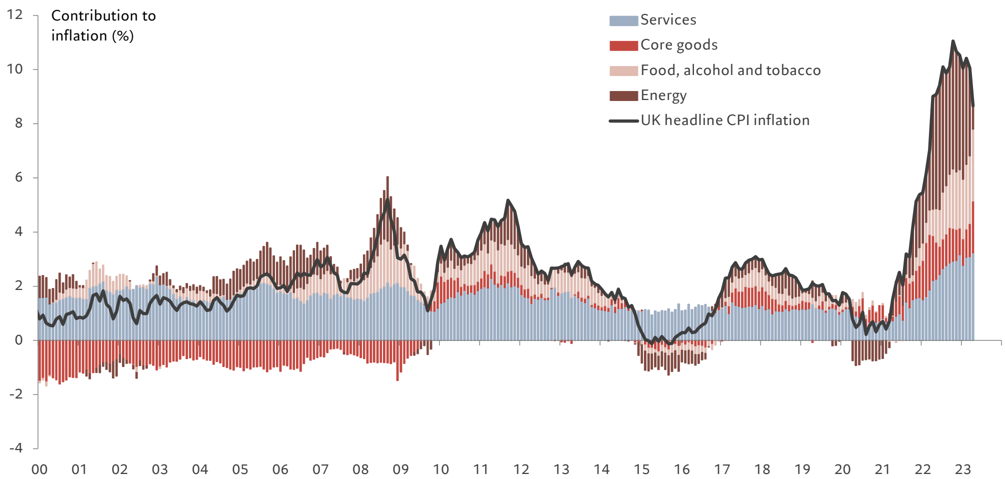
Strong inflation data have put renewed pressure on the BoE to hike rates further over the next few months, and to keep them at higher levels for longer than initially anticipated. While lower energy prices have pushed headline CPI lower, to 8.7% year-over-year in April, **core inflation unexpectedly rose to 6.8% driven by both goods and services**. Special factors likely played a role in April, including some degree of indexation of CPI components based on past energy prices, but by and large there is no escaping the stickiness of core inflation in the UK.

Services inflation remains particularly high and sticky, adding to the risks of a de-anchoring in expectations by more than in most other developed economies. Wage growth may have peaked following a large increase at the start of this year, but at 6-7% it remains well above the level consistent with the BoE's definition of price stability. Meanwhile, indicators of labour market tightness are still consistent with ongoing upward pressure on pay growth.

On a more encouraging note, supply chains are still improving and imported inflation easing, consistent with a decline in core goods inflation over the coming months. At the headline level, **lower energy and food prices will likely push CPI inflation lower in H2, and below 5% by the end of the year according to our forecasts.**

Although we still view a weak supply-side as the UK's main source of underlying inflationary pressures, the latest indicators have also been consistent with resilient demand. Credit conditions have tightened significantly but the overall impact on the real economy has been relatively contained so far. Real GDP has been essentially flat since early 2022, meaning that the UK has avoided the (large) recession that everyone anticipated. The labour market has been resilient, and retail sales have recently surprised to the upside. True, most of the tailwinds to household consumption have come from the fall in energy prices, but **the broader economy has proved to be much more resilient than expected.**

Chart 1: breakdown of UK CPI inflation drivers



Source: Pictet WM CIO Office & Macro Research, ONS, 24 May 2023

At the May meeting of the Monetary Policy Committee, the BoE said that further monetary tightening would be required "if there were to be evidence of more persistent pressures". Since then, Governor Bailey reiterated the BoE's "absolute commitment" to price stability, although the BoE's policy stance will remain data dependent and flexible. **Our base case had been for the BoE to deliver a final rate hike in June, to 4.75%, but recent data will likely force them to err on the hawkish side** until they see convincing evidence of a turnaround in inflation dynamics.

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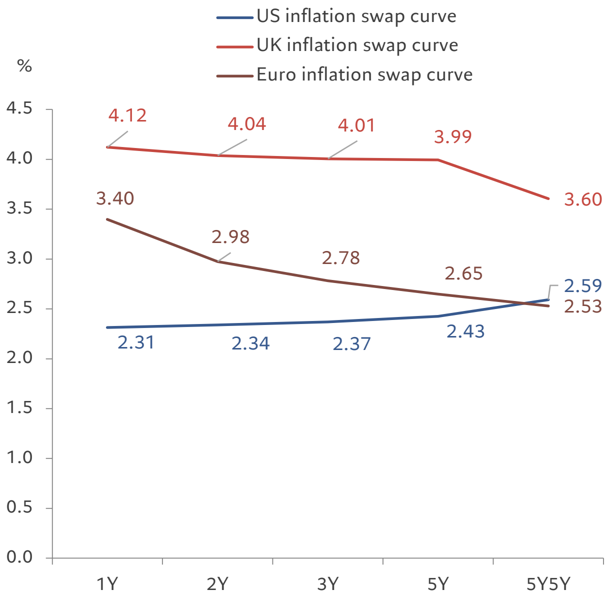
In this context, market participants have repriced the path for UK policy rates higher, **with a terminal rate not far from 5.5% by the end of the year** (implying almost three more rate hikes, on 30 May), and only limited rate cuts priced in thereafter. Meanwhile, **the UK inflation swap curve now shows headline inflation around 4% over the next five years, which is well above the BoE's 2% long-term target** (*see chart 2*).

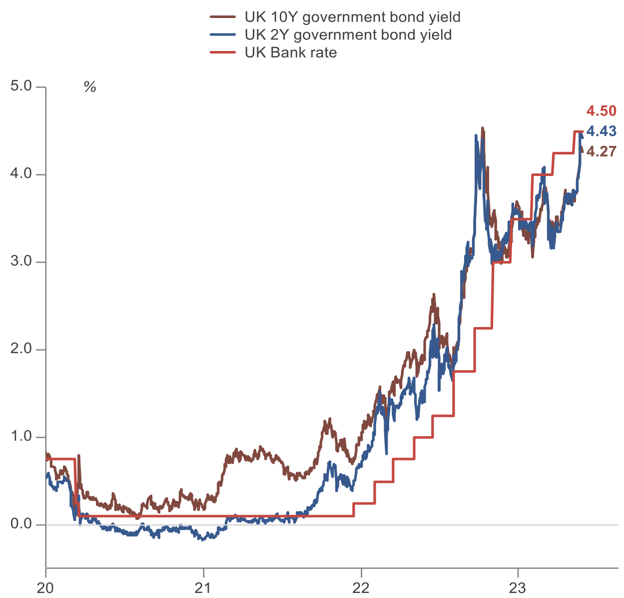
This sharp repricing of the BoE's expected rate path has caused a surge in UK sovereign bond yields, with the two-year yield, which is more sensitive to monetary policy, reaching 4.43% (on 30 May, *see chart 3*). This is not far from the levels it reached last September during the scare around the 'mini budget' of ex-prime minister Liz Truss. **The 10-year UK gilt yield now trades well above its US counterpart at 4.27%** (against 3.70%, on 30 May), **making it the highest yielder among long-dated core sovereign bonds.**

Chart 2: US, UK and euro inflation swaps curves



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 30.05.2023

Chart 3: UK policy rate and sovereign bond yields



Source: Pictet Wealth Management, FactSet, 30.05.2023

Although current market pricing seems elevated to us given the risk of slowing economic growth and base effects that should lower headline inflation in H2, we expect **that 10-year gilt yields could remain above 4% for some time**. Nevertheless, **the fact that investors' base seems to be slowly shifting**, with UK pension funds lowering their share of gilts holdings as a percentage of total outstanding (from 26.5% in Q4 2021 to 24.2% in Q4 2022), while foreigners have increased theirs (from 28.3% in Q4 2021 to 30.9% in Q4 2022 according to the Office for National Statistics (ONS)), **suggests that the recent surge in yields could be somewhat capped.**

In fact, not only do most **UK sovereign bonds trade at higher yields than their US counterparts across the curve, once hedged, the yield pick-up is even higher for**

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US dollar investors (+60 bps for a three-month GBPUSD hedge) and with a three-month EURGBP hedging cost of only 1.4% annualised, the 10-year gilt yield once hedged in euros still remains higher than its German counterpart (2.83% versus 2.36% for the 10-year German Bund, on 30 May). **This likely explains the increasing inflows from foreigners into the gilt market at the expense of UK pension funds**, which may have downsized their gilt allocation in the aftermath of the liability-driven investment (LDI) strategies debacle last autumn.

In a context where **elevated and sticky inflation could keep the BoE on its toes, we have revised our 10-year gilt yield year-end forecast significantly higher, from 3.3% to 4.0%,** believing persistently high rates will likely be needed to tackle inflation. However, **we do not expect the recent surge in yields to continue in H2,** both because of deteriorating economic growth prospects and falling inflation thanks to favourable base-effects. Finally, **UK gilts have become increasingly attractive for foreign investors now that they offer the highest yields in the core sovereign bond space**, even once hedging costs are taken into account. But for investors' confidence to be retained both the BoE and the UK government need to stay the course in maintaining the UK public debt trajectory on a sustainable path.

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