ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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Bank expected to hold rates, and growth disappoints in October

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Introduction: the MPC unlikely to increase Bank Rate next week

As we discussed last week, it looks very unlikely that the MPC will raise rates next week (announcement 16 December), despite the build-up of inflationary pressures.[1] As we commented then, Michael Saunders (one of the MPC's "hawks") had said, in the wake of the new anti-Covid restrictions announced on 27 November, that "…there could be particular advantages in waiting to see more evidence on its possible effects on public health outcomes and hence the economy".[2] Saunders was one of the only two MPC members who voted for a rise at the November MPC meeting. Saunders added that he believed that any increase in Bank Rate was likely to be limited "…provided we do not delay too long, it should be a case of easing off the accelerator rather than applying the brakes." It now seems that the any rate increase will be in February 2022, at the earliest. In addition, it is most unlikely there will be any change to the QE programme next week, so monetary policy will probably be left on hold.

There will not be a revised forecast at the December meeting but, for the record, November's forecast (4 November) is shown in table 1 below.[3] In November, the Bank included a further upward revision to their inflation forecast. The CPI forecasts showed inflation rising to 4¼% in 2021Q4, still being above target in 2022Q4 (3½%) and only moving near to target in 2023Q4. Specifically, Bank staff expected inflation to rise to just under 4% in October, though note the outturn was 4.2%.[4] CPI inflation was then expected to rise to 4½% in November and remain around that level through the winter. CPI inflation was then expected to peak at around 5% in April 2022, materially higher than expected in the August Report.

Even though there are no formal revised forecasts, the MPC's December minutes will, nevertheless, comment on economic developments. They can be expected to say inflation is now expected to exceed the November forecasts. Indeed, Deputy Governor Ben Broadbent said recently that inflation will "comfortably exceed" 5% this spring as energy prices and supply chain pressures continued to squeeze households.[5] He also commented that the labour market "looks to have tightened further" following the end of furlough. And he warned that this could prove to be a "more persistent source of inflation" than supply chain issues. Concerning growth prospects and the labour market, the MPC could suggest a downgrade to growth (given the weak October GDP figure and the imposition of the new anti-Covid restrictions) and offer further reflections on the labour market after the ending of the furlough scheme.

Table 1 Bank of England: November forecast, YOY (%), unless otherwise indicated

	2021	2022	2023	2024
GDP	7	5	1½	1
Unemployment rate (%), Q4	4½	4	4¼	4½
CPI inflation (YOY, %), Q4	4¼	3½	2¼	2
Household consumption	4¾	7¾	1½	1
Business investment	¾	16 ¾	1	-4
Net contribution of trade (%, GDP)	-1	-2	-¼	¼
Household saving ratio (%)	11¼	4½	3½	3¾
Average weekly earnings (YOY, %), Q4	3½	1¼	2¼	2¾
Bank Rate (%), Q4, August in brackets	0.2 (0.1)	1.0 (0.3)	1.1 (0.5)	1.0

Source: *Bank of England*, "Monetary Policy Report, November 2021", 4 November 2021.
The path for Bank Rate implied by forward market interest rates.

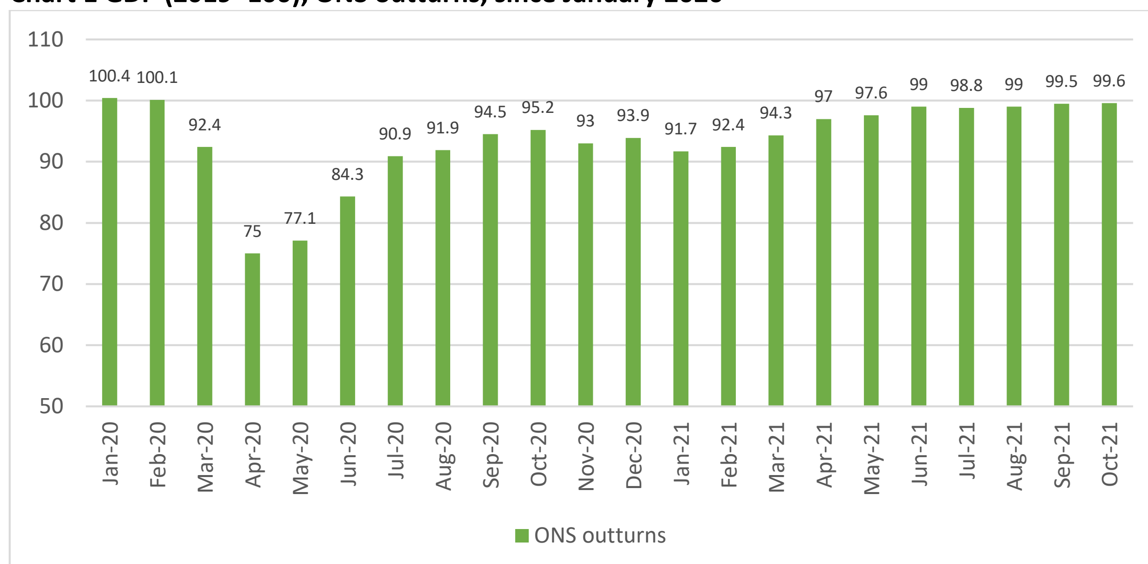
GDP rose by just 0.1% in October…

GDP increased by less-than-expected 0.1% (MOM) in October, after the 0.6% rise in September (chart 1) and was still 0.5% below pre-pandemic February 2020.[6] This sharp slowdown is all the more concerning given the renewed imposition of anti-Covid restrictions, which will inevitably curb activity (more below). Concerning the industrial breakdown, services grew but production and construction contracted in October.

The service sector grew by 0.4% (MOM) and reached its pre-pandemic February 2020 level.[7] Growth was driven by human health activities, which grew by 3.5%, mainly because of a continued rise in face-to-face appointments at GP surgeries in England. Consumer-facing services (retail trade, food and beverage serving activities, travel and transport, and entertainment and recreation) continued "underperform" the rest of the services sector. They were still 5.2% below their pre-pandemic levels, while all other services were 1.4% above.

Turning to production, output in the sector decreased by 0.6% (MOM) and was still 2.1% lower than in February 2020.[8] The monthly fall was mainly driven by a 2.9% fall in electricity and gas output, whilst mining and quarrying was down by 5.0%. Within production, the manufacturing sector was flat (MOM), and was 2.5% below February 2020's level. There was a mixed picture across the manufacturing sector. Most notably, the manufacture of machinery and equipment (not elsewhere classified) fell by 9.5%, but this was partially offset by a rise of 8.6% in the manufacture of basic pharmaceutical products and pharmaceutical preparations. Finally, construction output decreased by 1.8% (MOM) in October and the sector is now 2.8% below its pre-coronavirus pandemic level.[9] Construction output peaked at 0.9% above its pre-coronavirus pandemic level in April 2021, but since then the construction industry has faced challenges from rising input prices and delays to the availability of some construction products (notably steel, concrete, timber and glass).

Chart 1 GDP (2019=100), ONS outturns, since January 2020



Source: *ONS*, "GDP monthly estimate: October 2021", 10 December 2021.

…and more anti-Covid restrictions…

In last week's Perspective we reported the Prime Minister's new Covid-related restrictions, as announced on 27 November (for England).[10] Broadly, they specified that face coverings would be made compulsory in places including shops and hairdressers and on public transport (but hospitality settings would be exempt from the changes), everyone entering the UK would have to take PCR test by the end of the second day after their arrival and self-isolate until they receive a negative result, and all contacts of suspected omicron cases must self-isolate, regardless of whether or not they were fully jabbed. The Health Secretary then announced a tightening of travelling restrictions on 4 December so that every traveller coming to the UK would have to have a negative pre-departure Covid test in order to enter the country**.**

The Prime Minister announced further restrictions on 8 December (for England, "Plan B").[11] Broadly, they recommended working from home (WFH) where possible and wearing masks in more public places (including places of worship, theatres and cinemas, though places like pubs, restaurants and gyms were not included). In addition, people will need an NHS Covid Pass or a recent negative lateral flow test to gain entry into nightclubs, large indoor and outdoor unseated venues and all venues with capacity of more than 10,000.

Even though the new measures are still short of "lockdown", they will inevitably curb activity, especially in the hospitality and travel industries. And they raise uncertainty, not least of all about future Government policy relating to the omicron variant or, indeed, any future variants. The policy responses to the new variant will almost certainly undermine the growth outlook.

…whilst the trade balance improved a little in October

The total trade (goods & services, including precious metals) balance showed a <u>deficit</u> of £2.0bn in October 2021, as the goods deficit continued to outweigh the services surplus, compared with a <u>deficit</u> of £2.8bn in September.[12] There was, therefore, a modest improvement (£0.8bn) in the trade balance. The ONS's favoured "underlying" goods and services balance (excluding precious metals) also improved by about £0.8bn (see annex table 1).

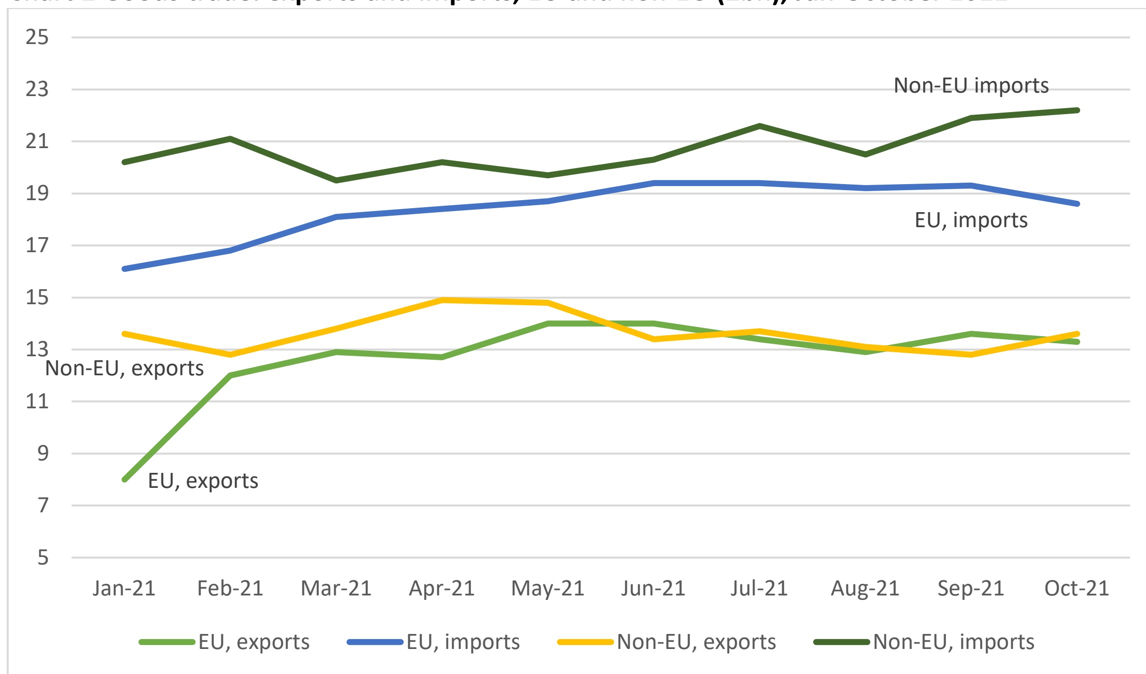
Concerning the components, the visible (goods, including precious metals) <u>deficit</u> narrowed to £13.9bn (from £14.7bn in September), as exports rose by 1.6% (MOM) but imports decreased by 0.9%. Both the EU and non-EU deficits improved:

- The deficit with the EU narrowed to £5.3bn (from £5.6bn), as exports fell 2.7% (MOM), whilst imports fell 3.5%. Exports of machinery and transport, chemicals, material manufactures and miscellaneous manufactures to the EU all decreased in October 2021. But fuel exports increased by £0.3bn, driven by increased gas exports to the Netherlands. The decrease in imports from the EU was largely because of falls in imports of machinery and transport equipment, chemicals and material manufactures. The ONS noted that the ongoing global semiconductor shortage had led to a decrease in car production in Europe and a subsequent fall in imports of cars from the EU.
- The deficit with non-EU countries narrowed to £8.6bn (from £9.1bn), as exports rose 6.2% whilst imports rose 1.4%. The increase in exports to non-EU countries was driven by increases in exports of chemicals, fuels and machinery and transport equipment. While imports from non-EU countries increased because of the large increase in fuel imports, though this increase was partly offset by falls in imports of machinery and transport equipment and miscellaneous manufactures. The fall in imports of machinery and transport equipment was largely driven by decreased imports of cars from China.

Concerning services, the surplus was very marginally lower at £11.9bn (£12.0bn in September), as exports grew by 0.4% (MOM), whilst imports rose by 1.2%.

The ONS noted that imports from non-EU countries were higher than from EU countries in September, for the 10th consecutive month since January 2021 (chart 2). The ONS also noted that "…previously announced timings of the UK leaving the EU and the subsequent transition period, along with the impact of the coronavirus pandemic, global recession and supply chain disruption, have caused higher levels of volatility in trade statistics in the past two years".

Chart 2 Goods trade: exports and imports, EU and non-EU (£bn), Jan-October 2021



Source: *ONS*, "UK trade: October 2021", 10 December 2021.

Markit surveys were fairly firm in November…

Markit surveys for November were fairly firm, though inflationary pressures remained a concern. Manufacturing and construction PMIs edged higher, whilst there was a slight easing in services. But note, crucially, the data were mainly collected before the Prime Minister's announcement of the tighter Covid-related restrictions on 27 November. Moreover, given the weakness of the October GDP data, it could be the Markit surveys are currently overly optimistic.

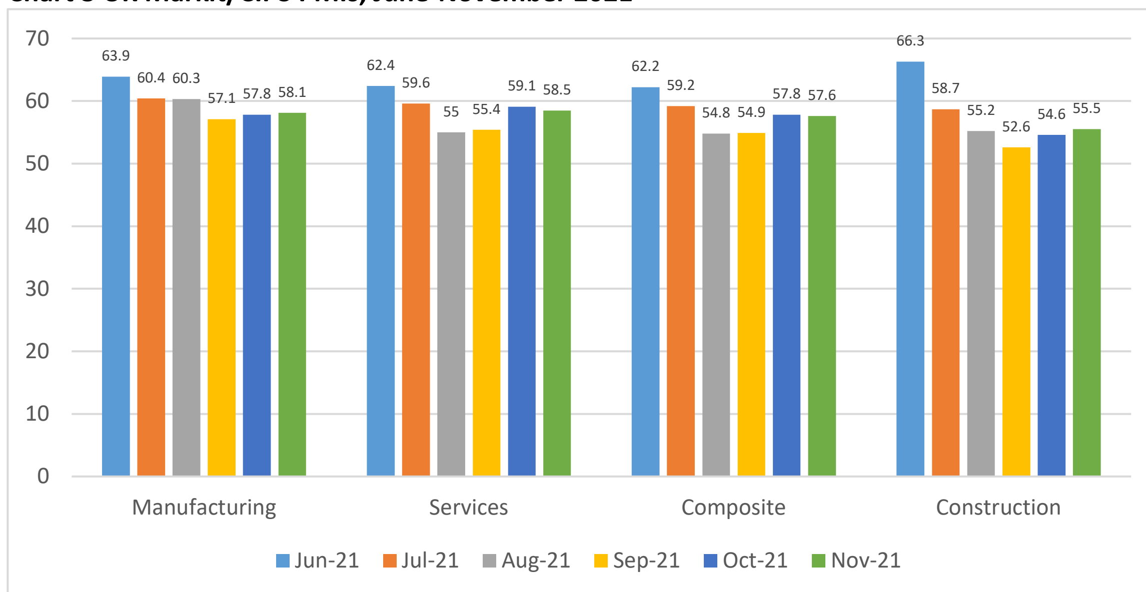
For the record, the results of the November survey were (chart 3):

- The Manufacturing PMI edged up in November to 58.1, after October's 57.8, well above the 50.0 no-change value.[13] However, there remained concerns over severely stretched supply chains, input and

labour shortages, and higher input prices. Manufacturers maintained a positive outlook during November, with business optimism rising to a three-month high. Within the PMI, output growth accelerated slightly from October's eight-month low (to 52.7 from October's 51.3).

- The Services PMI Business Activity Index eased slightly to 58.5 in November, after October's 3-month high of 59.1.[14] The survey showed export sales were a key factor supporting growth across the service economy in November, with looser travel restrictions contributing to the steepest upturn in new business from abroad since March 2017. But note this was before the new travel restrictions were announced, which are expected to undermine activity. The latest survey data highlighted another round of rapid cost inflation, driven by higher fuel prices, wages and utility bills.
- The seasonally adjusted UK Composite Output Index was 57.6 in November, marginally down on October's 57.8, reflecting the slight slowdown in services activity.[15] As noted already, manufacturing output growth accelerated slightly but service sector growth continued to outpace the manufacturing recovery. The Composite Output Index is a weighted average of the UK Manufacturing Output Index (not the PMI) and the UK Services Business Activity Index (PMI).
- The Construction Total Activity Index improved further to 55.5 in November, after October's 54.6, the fastest rise for four months.[16] A steeper rise in commercial construction helped offset a sight showdown in house building growth. There were signs that the worst phase of supplier delays may have passed. Rapid input price inflation persisted, and haulage driver shortages added to cost pressures, but the latest overall rise in operating expenses was the least marked for several months.

Chart 3 UK Markit/CIPS PMIs, June-November 2021



Sources: (i) Markit releases for manufacturing, services and construction PMIs for November 2021; (ii) previous releases for previous data.

…and so were house prices…

Last week we reported that the Nationwide had announced, perhaps surprisingly, that house prices rose by a buoyant 0.9% (MOM, seasonally adjusted) in November to be 10.0% higher YOY, after October's annual growth of 9.9%.[17-18] And this was despite the ending of the stamp duty holiday. For the record, the SDLT nil rate threshold (for England and Northern Ireland) was reduced from £500,000 to £250,000 on 1 July and reverted to £125,000 on 1 October. The tax holiday ended on 31 March 2021 in Scotland and on 30 June 2021 in Wales.

The Halifax supported the assessment that the housing market had been firm in November.[19] They reported that prices had risen by 1.0% (MOM), to be 8.2% higher (YOY) in November (unchanged from October). They said "…the performance of the market continues to be underpinned by a shortage of available properties, a strong labour market and keen competition amongst mortgage providers keeping rates close to historic lows". However, they added that "…looking ahead, there is now greater uncertainty

than has been the case for quite some time, with interest rates expected to rise to guard against further increases in inflation. Economic confidence may be also be dented by the emergence of the new omicron virus variant". And they commented "…leaving aside the direct impact of a possible resurgence in the pandemic for now, we would not expect the current level of house price growth to be sustained next year given that house price to income ratios are already historically high, and household budgets are only likely to come under greater pressure in the coming months."

…but car registrations remained depressed

The SMMT reported that November's new car registrations were just 1.7% (YOY) higher than lockdown-hit November 2020 and they were, moreover, 31.3% below the pre-pandemic five-year average as semiconductor shortages constrained supply.[20] Concerning the market breakdown, private demand saw an increase of 41.7% in November 2021 over lockdown-hit November 2020, taking the private market share to an unusual high of 54.1%. The number of new cars registered to large fleets declined by 24.7% (YOY), whilst business registrations were 11.2% (YOY) higher. Concerning the year-to-date data, total registrations were just 2.7% higher than lockdown-hit 2020.

Fed expected to discuss winding down of the asset purchases programme…

The Fed is also meeting next week (announcement on 15 December). Following on from some recent hawkish comments from Fed Chair Jerome Powell, it is expected that the FOMC will accelerate the winding down of the asset purchases programme. Interest rates are expected to be unchanged. In his evidence to the Senate Banking Committee on 30 November Powell said that the December FOMC meeting would discuss whether to end their bond purchases earlier than had been anticipated, noting the strong economy, stalled workforce growth, and high inflation that was expected to last into mid-2022.[21] The Fed announced it was reducing (tapering) its monthly asset purchases at its November meeting (announcement 3 November).[22]

On inflation he commented "…since the last meeting, we've seen basically elevated inflation pressures, we've seen very strong labour market data without any improvement in labour supply, we've seen strong spending data too". Powell expected that high inflation, characterised for some months as "transitory", was only expected to ease in 2022H2. Given how long high inflation had lasted, Powell said "I think it's probably a good time to retire that word". The recent data have confirmed that the labour market is tight, and inflation is uncomfortably high. The unemployment rate fell to 4.2% in November and the jobless claims were 184,000 in the week ending 4 December, the lowest level for initial claims since 6 September 1969 (when the level was 182,000).[23-24] The CPI inflation rate rose to 6.8% in November, whilst the Fed targeted PCE inflation rate was 5.0% in October.[25-27]

The Fed will be producing a revised set of economic forecasts for the December meeting. The last set was produced for the September (announcement 22 September) meeting.[28]

…whilst the ECB is expected to review its QE policy

The ECB is also meeting next week (announcement on 16 December). At the October meeting (announcement 28 October) the ECB left policy unchanged, having slowed the pace of pandemic emergency purchase programme (PEPP) purchases in September (announcement 9 September).[29-30]

The ECB's Governing Council is set to discuss the future of PEPP at next week's meeting (the programme is currently due to run until at least the end of March 2022).[31] Higher interest rates, most emphatically, are not expected. In October, the ECB said "…the key ECB interest rates [are expected] to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. This may also

imply a transitory period in which inflation is moderately above target". The ECB has a symmetric 2% inflation target.

Suffice to say, CPI inflation is considerably running above target. Eurostat's flash estimate for CPI inflation for the Eurozone was 4.9% in November, up from 4.1% in October.[32-33] The energy component had by far the highest annual rate in November (27.4%, compared with October's 23.7%), whilst CPI inflation excluding energy was just 2.5%. The individual member states' inflation rates varied considerably. They included Belgium (7.1%), Germany (6.0%), Netherlands (5.6%), Spain (5.6%), Italy (4.0%), and France (3.4%). The ECB will be producing a revised set of economic forecasts for the December meeting. The last set was produced for the September meeting.[34]

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28. Ruth Lea, "The MPC in September: growth seen weaker and inflation higher than in August", *Arbuthnot Banking Group*, 27 September 2021, discussed the Fed's September meeting (announcement 22 September 2021).
29. Ruth Lea, "MPC unexpectedly leaves monetary policy unchanged", *Arbuthnot Banking Group*, 8 November 2021, discussed the ECB's October meeting (announcement 28 October 2021).
30. Ruth Lea, "Disappointing GDP data in July, as the recovery slows", *Arbuthnot Banking Group*, 13 September 2021, discussed the ECB's September meeting (announcement 9 September 2021). At this meeting Christine Lagarde pegged December as the time when ECB policymakers would discuss the future of PEPP.
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Annex

Table 1 Trade (goods and services) in October, balances (£bn), exports and imports (% change)

	Monthly balances (£bn)			Exports and imports (Oct, MOM, %)	
	Sep 2021	Oct 2021	Change	Exports	Imports
Total balances:					
Goods (total): of which EU/non-EU:	-14.7	-13.9	+0.8	1.6	-0.9
• EU	-5.6	-5.3	+0.3	-2.7	-3.5
• Non-EU	-9.1	-8.6	+0.5	6.2	1.4
Services	12.0	11.0	-0.1	0.4	1.2
Goods and services	-2.8	-2.0	+0.7	…	…
“Underlying” balances:					
Goods (excluding precious metals): of which EU/non-EU:	-14.5	-13.7	+0.8	…	…
• EU	-5.6	-5.3	+0.3	…	…
• Non-EU	-8.9	-8.4	+0.5	…	…
Services	12.0	11.9	-0.1	…	…
Goods and services	-2.6	-1.8	+0.8	…	…
Precious metals: of which EU/non-EU:	-0.2	-0.3	-0.1	…	…
• EU	0	0	0	…	…
• Non-EU	-0.2	-0.3	-0.1	…	…

Source: *ONS*, “UK trade: October”, 10 December 2021. There are rounding errors in the table.