

Arlingclose Economic and Interest Rate Forecast – June 2021

The medium term global economic outlook has continued to improve with the rollout of vaccination programmes. The UK has continued to benefit from its initial rapid vaccine rollout and has shifted focus onto second vaccinations to increase protection to counter a potential third COVID wave.

The opening up of the UK economy in the second and third quarter of 2021 will see sharp increases in GDP. The more upbeat assessment is that GDP will have grown by 5.5 per cent in Quarter 2, up from the 4.3 per cent May forecast, suggesting the economy has less catching up to do in the second half of 2021 to regain the pre-Covid peak.

Inflation has moved above the Bank of England's 2 per cent target. Alongside the increase in commodity prices, the Monetary Policy Committee has acknowledged the prospect of a sharper upturn in inflation, with the potential CPI could rise above 3 per cent in the coming months. However, the nature of the commodity price rise and the base effect easing, this is likely a transitory effect.

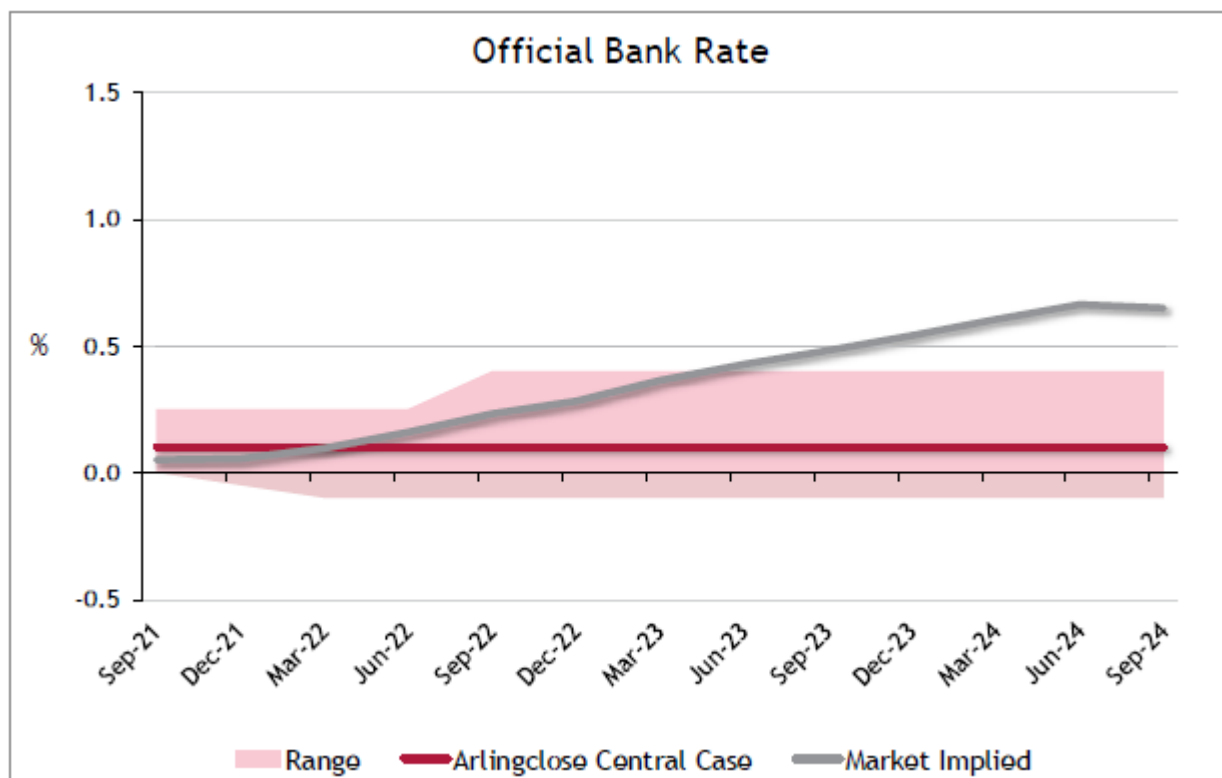
While downside risks seem to have reduced after recent trends in GDP and labour, the increase in near term inflation, being driven primarily by supply issues, is likely to have negative effects on output growth, providing a further reason for central banks not to tighten policy.

Longer term yields have declined over the last month largely due to the previous pricing in of potential monetary policy changes. As these have receded, the longer dated yields has shifted, with shorter term rates increasing slightly. Uncertainty remains with potential upside and downside risks providing a volatile intraday market.

Some upward pressure on gilt yields could remain in the short term due to the preponderance of strong data, but this is likely to ease once inflation fears recede as the effect of weak base effects subsides and growth figures return to more normal levels.

Arlingclose expects Bank Rate to remain at the current 0.1 per cent level. The risk of movement in Bank Rate in the short term is low, although the risks are leaning to the upside.

The graph below shows the Arlingclose central case along with upside and downside risks for Official Bank of England Base Rate.



Gilt yields could increase in the short term, but will begin to plateau and reduce once the market's expectations of rises in Bank Rate and inflation fears subside.

Longer term yields may face upward pressure towards the end of the forecast period as the economy moves back to a sustained footing and policy expectations start to strengthen.

Downside risks remain as the risk of further virus mutations including the delta variant could destabilise the recovery.

The graph below shows the Arlingclose central case along with the upside and downside risks for 20 year gilt yields.

