Arlingclose Economic and Interest Rate Forecast – September 2021

The global economy continues to recover from the pandemic but has entered a more challenging phase. The resurgence of demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. This is particularly apparent in the UK due to the impact of Brexit.

While Q2 UK Gross Domestic Product (GDP) expanded more quickly than initially thought, the 'pingdemic' and more latterly supply disruption will leave Q3 GDP broadly stagnant. The outlook also appears weaker. Household spending, the driver of the recovery to date, is under pressure from a combination of retail energy price rises, the end of government support programmes and soon, tax rises. Government spending, the other driver of recovery, will slow considerably as the economy is taken off life support.

Inflation rose to 3.2% in August. A combination of factors will drive this to over 4% in the near term. While the transitory factors affecting inflation, including the low base effect of 2020, are expected to unwind over time, the Monetary Policy Committee (MPC) has recently communicated fears that these transitory factors will feed longer-term inflation expectations that require tighter monetary policy to control. This has driven interest rate expectations substantially higher.

The supply imbalances are apparent in the labour market. While wage growth is currently elevated due to compositional and base factors, stories abound of higher wages for certain sectors, driving inflation expectations. It is uncertain whether a broad-based increased in wages is possible given the pressures on businesses.

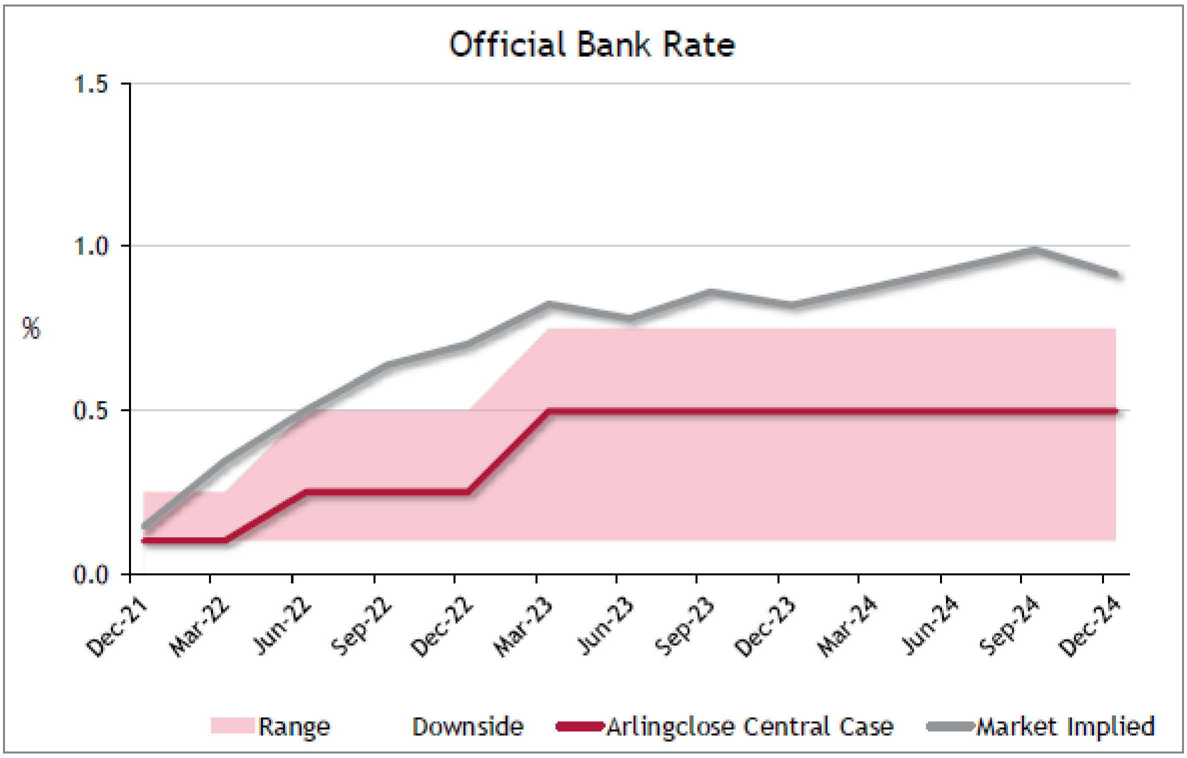
Government bond yields increased sharply following the September Federal Open Market Committee (FOMC) and Monetary Policy Committee (MPC) minutes, in which both central banks communicated a lower tolerance for higher inflation than previously thought. The MPC in particular has doubled-down on these signals in spite of softer economic data. Bond investors expect higher near term interest rates but are also clearly uncertain about central bank policy.

The MPC appears to be playing both sides, but has made clear its intentions to tighten policy, possibly driven by a desire to move away from emergency levels. While the economic outlook will be challenging, the signals from policymakers suggest Bank Rate will rise unless data indicates a more severe slowdown.

Arlingclose expects Bank Rate to rise in Q2 2022. We believe this is driven as much by the Bank's desire to move from emergency levels as by fears of inflationary pressure. Given the current outlook, we believe this could be a policy mistake.

Investors have priced in multiple rises in Bank Rate to 1% by 2024. While we believe Bank Rate will rise, it is by a lesser extent than expected by markets.

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



Gilt yields have risen sharply as investors factor in higher interest rate and inflation expectations. From here, we believe that gilt yields will be broadly steady, before falling as inflation decreases and market expectations fall into line with our forecast.

The risk around our forecasts for Bank Rate is to the upside over the next few months, shifting to the downside in the medium term. The risks around the gilt yield forecasts are initially broadly balanced, shifting to the downside later.

The graph below shows the Arlingclose central case along with the market implied risks for 20 year gilt yields.