Arlingclose Economic and Interest Rate Forecast - December 2021

The global recovery from the pandemic has entered a more challenging phase. The resurgence in 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. The advent of the Omicron variant of coronavirus is affecting activity and is also a reminder of the potential downside risks.

Despite relatively buoyant activity survey data, official Gross Domestic Product (GDP) data indicates that growth was weakening into Quarter 4 2021. Other data, however, suggested continued momentum, particularly for November. Retail sales volumes rose 1.4 per cent and the labour market continued to strengthen. The end of furlough did not appear to have had a significant impact on unemployment. Wage growth is elevated.

The Consumer Price Index inflation rate rose to 5.1 per cent for November and will rise higher in the near term. While the transitory factors affecting inflation are expected to unwind over time, policymakers' concern is persistent medium term price pressure.

These factors prompted the Monetary Policy Committee (MPC) to raise Bank Rate to 0.25 per cent at the December meeting. Short term interest rate expectations remain elevated.

The outlook, however, appears weaker. Household spending faces pressures from a combination of higher prices and tax rises. In the immediate term, the Omicron variant has already affected growth – Quarter 4 and Quarter 1 activity could be weak at best.

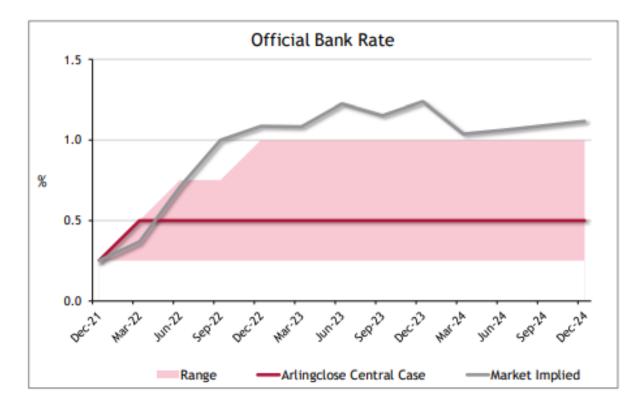
Longer-term government bond yields remain relatively low despite the more hawkish signals from the Bank of England and the Federal Reserve. Investors are concerned that significant policy tightening in the near term will slow growth and prompt the need for looser policy later. Geo-political and coronavirus risks are also driving safe haven buying. The result is a much flatter yield curve, as short-term yields rise even as long-term yields fall.

The rise in Bank Rate despite the Omicron variant signals that the MPC will act to bring inflation down whatever the environment. It has also made clear its intentions to tighten policy further. While the economic outlook will be challenging, the signals from policymakers suggest their preference is to tighten policy unless data indicates a more severe slowdown.

The MPC will want to build on the strong message it delivered this month by tightening policy despite Omicron uncertainty.

Arlingclose therefore expects Bank Rate to rise to 0.50 per cent in Quarter 1 2022, but then remain there. Risks to the forecast are initially weighted to the upside, but becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.

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



Gilt yields will remain broadly flat from current levels. Yields have fallen sharply at the longer end of the yield curve, but expectations of a rise in Bank Rate have maintained short term gilt yields at higher levels.

Easing expectations for Bank Rate over time could prompt the yield curve to steepen, as investors build in higher inflation expectations.

The risks around the gilt yield forecasts vary. The risk for short and medium term yields is initially on the upside but shifts lower later. The risk for long term yields is weighted to the upside

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

