Arlingclose Economic and Interest Rate Forecast – June 2023

UK inflation and wage growth has proven to be even more stubborn, with headline rates remaining steady, core rates rising, and wage growth accelerating. As a result, the Bank of England sought to shock markets and underline its inflation fighting credentials by increasing Bank Rate by 50 basis points to 5.0 per cent. However, this is unlikely to be the peak.

The UK economy has been resilient in the face of the dual headwinds of inflation and interest rates, albeit the majority rise in Bank Rate is yet to impact households. Government cost of living support, stronger wage growth and household savings have had an offsetting effect, while timing issues around mortgage resets have delayed the impact of monetary tightening.

Employment demand has remained strong and, alongside inflation expectations, has driven stronger wage growth. This in turn is adding upward pressure to inflation, particularly services inflation. Core Consumer Price Index and services inflation have increased of late despite previous monetary tightening.

The Bank's credibility issues mean that it can no longer afford to wait until the effect of past increases in Bank Rate affect activity. This suggests that further monetary tightening is necessary to have the desired immediate effect on inflation.

However, the lagged effect of aggressive monetary tightening will increasingly pressure economic activity. A recession appears inevitable. Household spending will be affected by increases in mortgage payments, while business investment/spending will fall back due to higher borrowing costs. Unemployment will increase.

Inflation will fall sharply this year, albeit at a slower pace than expected. Recessionary conditions eventually create downside risks for inflation and will entail monetary easing in the medium term to stimulate economic activity.

Global bond yields remain volatile, although UK gilt yields have been more affected by its seemingly idiosyncratic inflation issues. The Federal Reserve and other central banks see persistently higher policy rates through 2023 as key to dampening. domestic inflationary pressure.

Downside risks for bond yields arising from a global economic slowdown are increasing.

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