

Arlingclose Economic and Interest Rate Forecast – September 2023

UK inflation and wage growth remain elevated, but the August Consumer Price Index (CPI) data suggested that inflation was falling more rapidly. In a narrow 5-4 vote, the Monetary Policy Committee (MPC) took the opportunity to hold rates at 5.25 per cent, a level we see as the peak. Near-term rate cuts are unlikely, although downside risks will increase as the UK economy inevitably slides into recession.

While the MPC vote was close, and the minutes contained the warning about the need for further tightening if inflationary pressures persist, both the decline in closely watched inflation measures and confidence that wage growth had peaked, clearly allowed policymakers to focus on the weaker activity data.

The UK economy has so far been resilient. However, recent data indicates a further deceleration in business and household activity growth as higher interest rates start to bite. Global demand will be soft, so offer little assistance in offsetting weakening domestic demand. A recession remains a likely outcome.

Employment demand has weakened and unemployment has increased, although the tight labour market has resulted in higher nominal wage growth. Anecdotal evidence suggests slowing recruitment and wage growth, and we expect unemployment to rise.

Consumer confidence has improved due to signs of real wage growth amid strength in the labour market, but household spending will remain weak as mortgaged households suffer higher interest payments and unemployment rises. Business investment / spending will fall back due to higher borrowing costs and weaker demand.

Inflation will continue to fall over the next 12 months, albeit with upside risk. The MPC's attention will remain on underlying inflation measures and wage data. Policy rates will remain at the peak for another 10 to 12 months, until the MPC is comfortable the risk of further second round effects have diminished.

Maintaining monetary policy in restrictive territory for so long, when the economy is already struggling (as the recent PMI data indicate), will require significant policy loosening in the future to boost demand and inflation.

Global bond yields remain volatile. Like the UK, the Federal Reserve and other central banks see persistently higher policy rates through 2023 to 2024 as key to dampening domestic inflationary pressure. Data points will therefore prompt changes in bond yields as global interest rate expectations shift.

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

