UK Economic Comment
February QIR – déjà vu all over again

Economics

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February Quarterly Inflation Report acknowledges stronger growth once again

The Bank of England (BoE) today published the latest Quarterly Inflation Report (QIR). As in the previous report, there was a material upward revision to near-term GDP forecasts following a more robust outturn in the most recent quarter. Consistent with that, the MPC confirmed the recently completed series of Gilt purchases conducted as an extension of Quantitative Easing (QE) will not be continued at this time.

2017 GDP now forecast to be +2.0%, 2018 revised up fractionally to 1.6%

For the second quarter in a row, the BoE acknowledged that growth in the intervening period had been more robust than anticipated. Due to a combination of recent domestic fiscal easing, firmer momentum in global activity, higher global equity prices, and more supportive credit conditions for households in particular, the MPC revised its forecast for GDP in 2017 from 1.4% to 2.0%. Growth in 2018 is expected to be 1.6% (up from 1.5%), and in 2019 1.7%.

CPI forecasts unchanged as higher market rates offset recent stronger growth

There was little change to median CPI projections over the forecast horizon. The potential impact from the improved GDP forecast was offset by the recent appreciation of sterling and the rise in market interest rates in the first month of 2017. The MPC lowered its estimate of the equilibrium unemployment rate from 5.0% to 4.5%, increasing the likelihood of subdued earnings under current labour market dynamics, and by extension raising the risk that accelerating inflation will squeeze real wages.

Brighter near-term outlook still clouded by EU exit-related concerns

The press conference that followed the publication of the QIR was notable for its repeated references to the forthcoming two-year EU exit process, which after yesterday's vote in the House of Commons looks ever more likely to begin within the next two months. The Governor noted that this journey is "really just beginning", highlighting that the events of the coming months could cause a sharp deviation in the anticipated evolution of growth, inflation, labour market dynamics, and the currency.

Weaker consumption and investment to tilt the MPC back to an easing bias

A key determinant of the MPC's assessment of the outlook over the coming months will be the extent to which inflation accelerates – particularly at the consumer level – and whether that acceleration is matched in the pace of average earnings. If wages do strengthen materially, the MPC will warn of a need to tighten policy in response, whereas if (as we expect) they fail to do so as companies enact more defensive investment plans, concerns of a significant squeeze on real earnings will mount, and raise the possibility that the MPC may need to try and ease monetary conditions to offset the potential hit to consumption such a squeeze will exert. The resultant growing speculation of a return of QE would support our expectation that Gilts are set to outperform their US and core Eurozone equivalents.

Sterling downdraft set to resume as EU exit and current account deficit weigh

Today's decision is consistent with our bearish sterling view, as the market expected a shift to a more hawkish stance that failed to materialise. Risks with regard to near-term activity are arguably skewed to the downside from here. We expect post-referendum resilience to be tested in a more lasting manner as EU exit negotiations get under way shortly. We think risks are skewed towards additional policy easing in the coming months, which should weigh on sterling. Lastly, as we have argued repeatedly, the main vulnerability of the UK economy lies in its (still) large current account deficit. We expect the rebalancing of the external sector to be the main medium-term driver of the currency and it could bring EUR/GBP closer to our end-17 target of parity.

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GDP revised up again, but CPI forecast unchanged from November

The BoE revised its forecast for GDP in 2017 from 1.4% to 2.0%, but expects growth to slow next year

The Bank of England published its latest Quarterly Inflation Report (QIR) today, alongside the decision and minutes of the Monetary Policy Committee (MPC)'s announcement on policy (on hold, no further Gilt purchases under QE at this time, remaining corporate bond purchases to run their course). As expected, they revised up their forecast for 2017 GDP, but the upgrade from 1.4% to 2.0% was more material than we had expected. The forecast for 2018 was also revised up, though much more modestly, from 1.5% to 1.6%, meaning the BoE now expect growth to slow throughout the next two years in line with our view (Figure 1, albeit the pace of growth in their forecasts is significantly faster than we anticipate).

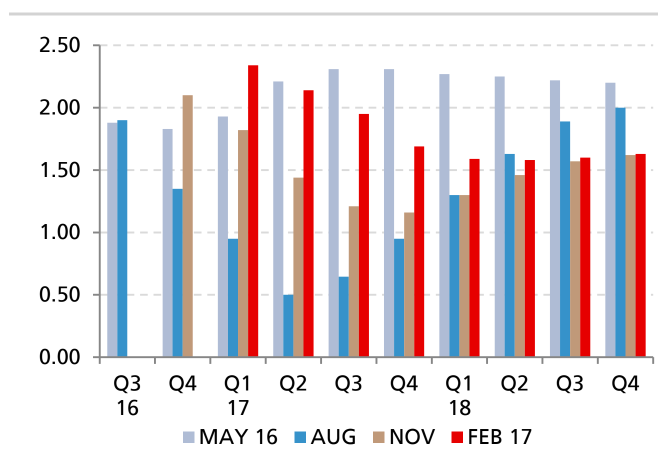
The four main factors cited as being responsible for the upward revision to the 2017 GDP forecast were (in order of descending importance) the fiscal boost announced by the Chancellor at the Autumn Statement late last year, firmer momentum in global activity, higher global equity prices, and more supportive credit conditions, particularly for households. There was also a mathematical impact from the stronger-than-expected outturn for GDP in Q4 2016 (+0.6% q/q, compared to the BoE's expectation of +0.4%)

CPI forecasts were little changed, due to the stronger pound, higher market interest rates, and a lowering of the estimated equilibrium rate of unemployment

It was notable that despite this material upgrade to growth expectations, there was almost no change at all to the BoE's median CPI forecast over the three-year horizon compared to the previous QIR (Figure 2). The first two factors explaining this projection were ones we had identified ourselves as likely offsets to the impact of more rapid growth – the stronger-than-expected performance of sterling over the past few months, and the material rise in short-dated interest rates – but the third was much the most interesting.

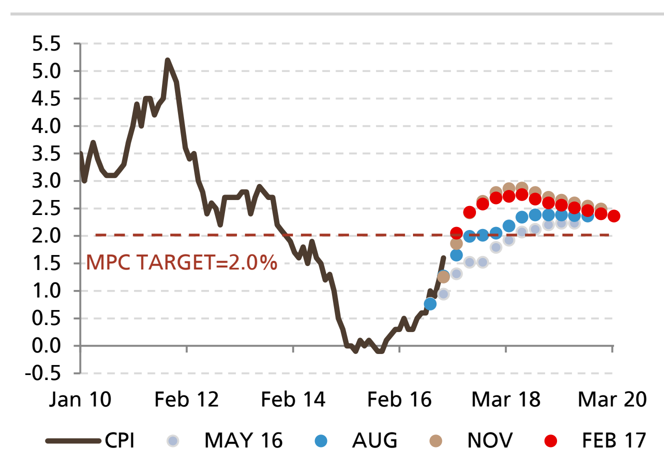
The BoE now believes that the equilibrium unemployment rate may be 4.5%, significantly lower than its prior estimate of 5.0%. Looking back, this is used as an explanation of the BoE's repeated tendency to overestimate the acceleration of average earnings, while looking forward it suggests more slack than previously thought in the labour market, a lower likelihood than previously thought of wages rapidly following inflation higher, and thus a higher probability of a squeeze on real disposable incomes and consumption.

Figure 1: Bank of England QIR GDP median forecasts (% y/y)



Source: Bank of England QIR, UBS Global Research

Figure 2: CPI (% y/y, Jan 2010-Dec 2016) and Bank of England QIR median forecasts (quarter average)



Source: ONS, Bank of England QIR, UBS Global Research

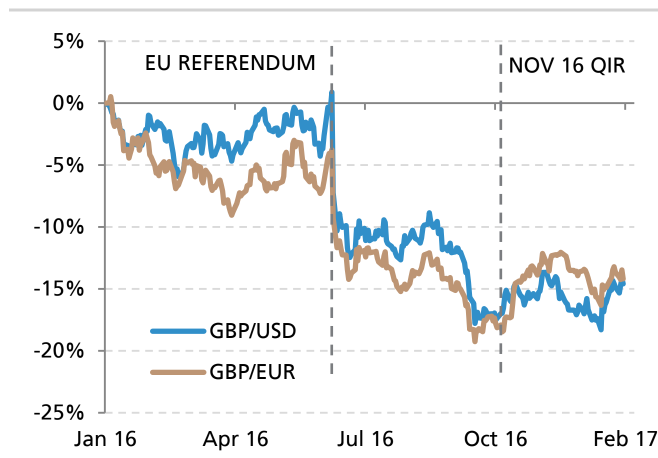
Recent consolidation of sterling expected to come to an end

The tone was less hawkish than expected, and we expect sterling to resume its downtrend

Today's decision is consistent with our bearish sterling view, as the market expected a shift to a more hawkish stance that failed to materialise. Risks with regard to near-term activity are arguably skewed to the downside from here. We expect post-referendum resilience to be tested in a more lasting manner as EU exit negotiations get under way shortly. We think risks are skewed towards additional policy easing in the coming months, which should weigh on sterling. Lastly, as we have argued repeatedly, the main vulnerability of the UK economy lies in its (still) large current account deficit. We expect the rebalancing of the external sector to be the main medium-term driver of the currency and it could bring EUR/GBP closer to our end-17 target of parity.

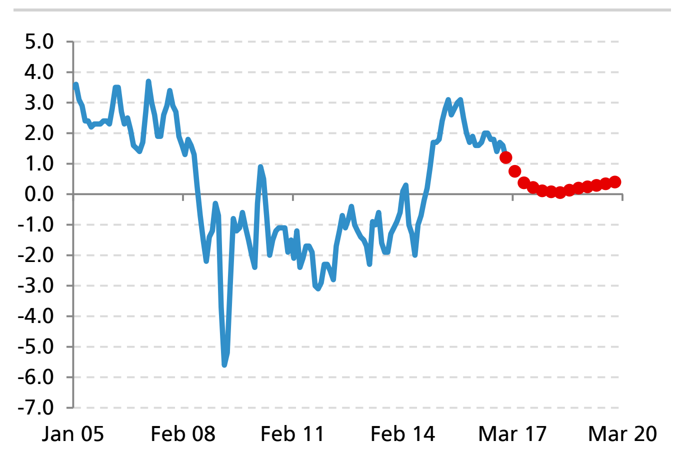
After collapsing in the immediate aftermath of the EU referendum in mid-2016, and having continued to slide more gradually since the Prime Minister confirmed at the Conservative Party Conference in September that she intended to trigger Article 50 and begin the UK's formal exit from the EU by the end of the current quarter, sterling has been more resilient over the past three months (Figure 3). Our overall assessment of the prospects ahead for the UK, both in terms of the performance of the economy and with respect to the many risks arising from the lengthy EU exit process, lead us to conclude that sterling has some way further to fall, and the outcome of today's QIR could be the catalyst for the next move to the downside.

Figure 3: Percentage change since 1st January 2016 in the level of sterling against the US dollar and the Euro



Source: Bloomberg, UBS Global Research

Figure 4: Real earnings (whole economy average earnings less CPI %y/y), with illustration if CPI rises in line with BoE median forecast and pace of nominal wage growth is unchanged at 2.8%



Source: ONS, Bank of England, UBS Global Research

Much will depend on the performance of the UK consumer

As so often in the UK economic outlook, the strength of private sector consumption will go a long way to determining which direction the MPC's next policy move is in, and when it may occur. There was a lot of discussion in the QIR itself and in the press conference of some important potential determinants of this, including the evolution of real earnings, the forecast for a sharp fall in the savings ratio, and the associated question of how resilient consumer confidence may be over the forecast horizon.

Paraphrasing the Governor, he even said that the MPC may need to ease policy if spending growth slows more than expected, but that conversely they may need to consider raising rates if pay growth rises more quickly than anticipated. With regard to this latter point, one of the most important pieces of information contained in the QIR was the BoE's suggestion that the equilibrium rate of unemployment in the UK may be as low as 4.5%, having previously been estimated to be 5.0%.

Policy may need to be eased if spending growth slows more than expected, or tightened if pay growth exceeds new forecasts

This is deemed a possible explanation for the repeated tendency over the past few years for the Bank to overestimate the extent to which wage inflation would rebound, and in light of this new estimate, the BoE now forecasts average earnings accelerating to 3.25% over the forecast horizon. This is well below the 4.3% rate being forecast a year ago, and, if an accurate forecast, will mean the likelihood of a squeeze on real earnings, triggering a drop in consumption, is raised significantly. Figure 4 shows what will happen to real earnings if CPI accelerates in line with the BoE's February QIR forecast while whole economy nominal average earnings continue to grow at their current rate of 2.8% y/y.

We are more pessimistic than the MPC on the outlook for consumers

We do not expect earnings to accelerate even to the extent predicted by the BoE in its new forecast, believing that companies will act increasingly defensively on investment and employment as the deadline for the UK's exit from the EU, and the possibility of dramatic changes in current trading and business relationships, moves ever closer. We also think CPI will accelerate more quickly, and to a slightly higher level, than the BoE is predicting, and the combination of these forecasts points for us to an even more emphatic squeeze on real earnings and thus a more material challenge to consumers' ability to keep spending.

We forecast weaker earnings growth than the BoE, but a more rapid rise in CPI, and thus a more material squeeze on real wages

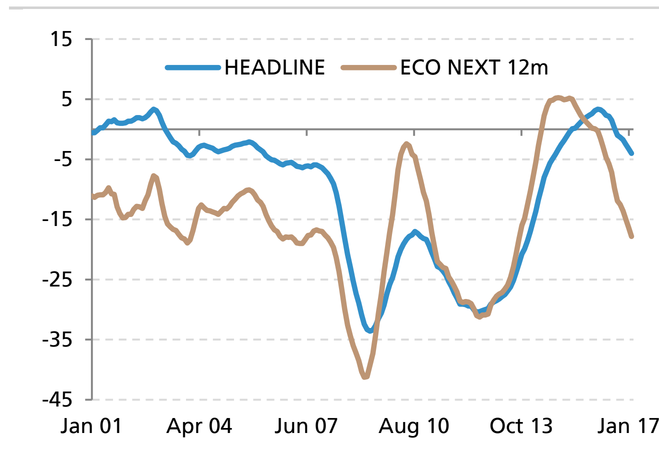
As well as the downside risks to consumption from these economic variables, we also see reasons to be concerned in current indicators of consumer confidence, which show the headline index clearly losing momentum and the sub-index for views on the economic situation over the next twelve months sliding sharply and reaching levels rarely recorded outside the financial crisis and the period shortly after it (Figure 5). Diminishing confidence and concern about what lies ahead for the economy are not consistent, in our view, with the drop in the household saving ratio predicted by the BoE, towards levels never seen in the 20-year history of the independent MPC (Figure 6).

Forward-looking consumer confidence indices have clearly turned lower in recent months

Other than in times of extreme need (such as at the onset of the financial crisis), households tend to respond to economic uncertainty by increasing, not reducing, their savings cushions. If real wages are squeezed as we expect, and households prove reticent to run down their savings, consumption will necessarily slow more significantly than the BoE expects, likely tilting the MPC back towards an easing bias.

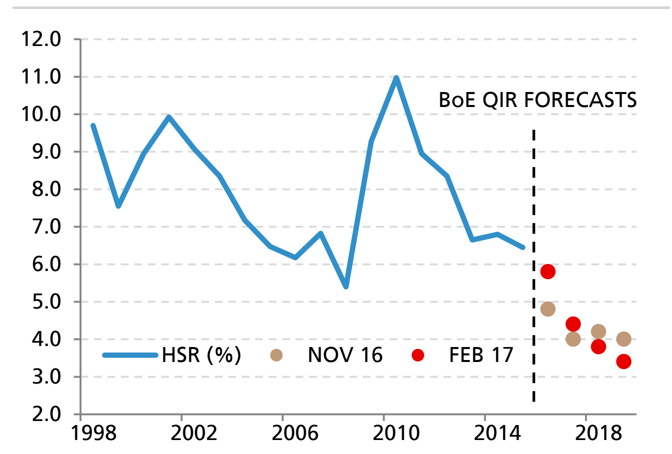
The forecast fall in the savings ratio may not materialise

Figure 5: Consumer confidence (headline index and economic situation, next 12 months, 12m moving averages)



Source: GfK, UBS Global Research

Figure 6: Household saving ratio (% of total available household resources) with BoE QIR forecasts



Source: ONS, Bank of England QIR, UBS Global Research

No increase in QE for now, £11.6bn reinvestment purchases confirmed

The APF will buy £11.6bn of Gilts over the next month as it reinvests the proceeds of a maturing issue

Consistent with the MPC's existing neutral policy stance, it was confirmed that the Gilt purchases conducted under the expansion of QE approved last August will not be added to at this time. Those purchases did not account for the reinvestment of the Asset Purchase Facility (APF)'s holding of the 1.75% 2017 Gilt that matured in late January. The MPC confirmed today an intention to keep reinvesting maturing Gilt holdings in the APF at least until the first hike in Bank Rate, meaning £11.6bn of Gilt purchases will be conducted over the next month. This should keep the stock of QE reserves constant, and avoid any passive reversal of earlier unconventional easing.

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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