

Virulent inflation raises pressure on the Bank of England

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The inflation battle is far from over in the UK. In fact, the nature of inflation is taking a new form as the root cause moves away from external to more domestically driven shocks. While the headline rate remained unchanged at 8.7%yoy in May, core inflation accelerated to 7.1% in May from 6.8% in April, marking the highest rate since March of 1992.

In response the Bank of England (BOE) raised interest rates by a bumper 50Bps to a 15-year high. While the Federal Reserve (Fed) and the European Central Bank (ECB) have made progress on bringing down inflation, the BOE still has some ways to go. Current market pricing assumes the terminal policy rate will go to 6% by year end³.

Source: Bloomberg, WisdomTree as of 23 June 2023.

Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties

UK inflation proving to be virulent

The UK has the most severe entrenched inflation problem across developed markets. The domestically driven increase of services prices advanced from 6.9% to 7.4%yoy in May⁴. As services are labour intensive, they are being impacted by strong wage gains. Employment growth has been stronger than projected underscoring continued robust demand for labour. This high demand caused the rise in weekly average earnings (ex-bonus) to 7.5% in April⁵, well above the BOE's forecast.

Brexit has been partly responsible for the rise in wages. Brexit reduced the mobility of European workers. The resulting lack of non-qualified workers has not yet been reabsorbed. The situation was clearly exacerbated during the Covid pandemic that left a large part of the workforce sick. The shortage of workers in the UK continues to weigh on the supply side and has been the key reason inflation has remained stubbornly high.

The resilient gains in employment (up 1.2% in April 2023⁶) have allowed UK households to continue spending on services. Thereby contributing to higher services inflation, prices for recreational and cultural goods and services rose by 6.8%yoy in May 2023⁷. At the same time, due to the shift away from floating rate mortgages towards fixed rate products over the last decade, the pass through of higher rates is taking longer to feed through the economy, thereby enabling the consumer to appear more resilient. However, headwinds are appearing from higher mortgage rates, with at least 800,000 fixed mortgages due to move

on to significantly higher rates in H2 2023⁸. Rents have also been rising, at an annualised pace of 5.6% in May compared to 3.2% in 2022⁹. This is likely to place further pressure on real disposable incomes and simultaneously fuel core inflation higher.

Source: Bank of England, Bloomberg, WisdomTree as of 31 March 2023.

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The Institute for Fiscal Studies estimates that higher interest rates will cause the average mortgage holder to suffer an 8.3% fall in disposable income compared to a scenario where rates remained at March 2022 levels. For 1.4 million of those borrowers, disposable income will fall by more than 20%¹⁰.

BOE guided dovish

The BOE's guidance implied that no further rate hikes should be needed bar evidence of more persistent inflationary pressures however the market ignored this. Money markets priced a terminal rate of 6.25% by February 2024¹¹. The BoE did not rule out further rate increases should the inflation data continue to be unfavourable. However, they did downplay the unexpected surge in core inflation in May owing to special contributing factors such as the sharp rise in vehicle excise duty and the erratic contribution of airfares and holiday packages. The BOE also highlighted that forward looking indicators are pointing to material falls in future wage inflation which could then lower the pressure on services prices.

We share that view, as producer price inflation which tends to serve as a leading indicator for consumer price inflation, eased more than expected in May. The June composite Purchasing Managers Indices (PMI) dropped for a second month in June, showing price pressures easing across the board, suggesting the economy could be turning.

Positive rate surprises are not always positive for the currency. The Pounds muted response (-0.17%)¹² to the BOE meeting despite the hawkish surprise and its negative reaction (-0.21%)¹³ to the hawkish May inflation data suggest that the BOE is prepared to endure a deeper slowdown in order to bring inflation under control. As a growth sensitive currency this is likely to remain an important headwind for the Pound.

1 Bloomberg as of 23 June 2023

2 Bank of England as of 22 June 2023

3 Bloomberg, as of 23 June 2023

4 Bank of England as of 21 June 2023

5 Office for National Statistics as of 31 May 2023

6 Office for National Statistics as of 31 May 2023

7 Bank of England as of 22 June 2023

8 Source: Bank of England, Bloomberg as of 22 June 2023

9 Office for National Statistics, as of 22 June 2023

10 Institute for Fiscal Studies as of 30 April 2023

11 Bloomberg as of 23 June 2023

12 Bloomberg GBP/USD as on 22 June 2023

13 Bloomberg GBP/USD as on 20 June 2023

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