UK: Poised for a spring recovery

Fast vaccinations and tumbling Covid-19 cases bode well for the UK's spring reopening. We expect 6% second quarter growth, but higher unemployment and a more nuanced savings story compared to the US, suggesting inflation may struggle to stay at-or-above target into 2022

A girl runs through the daffodils in bloom in St James's Park in central London, 26 February 2021

Source: Shutterstock

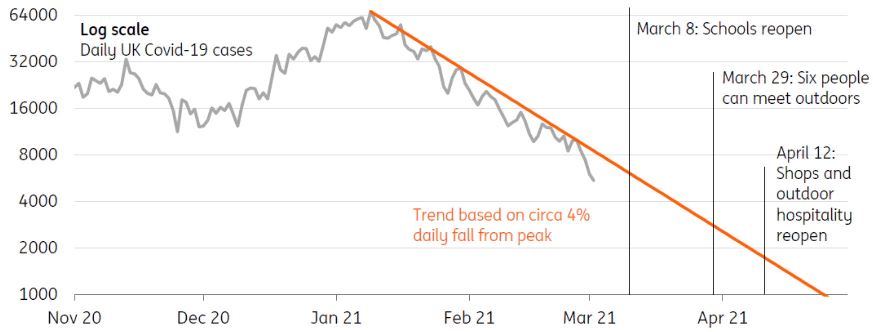
Fast vaccinations and tumbling cases bode well for spring

UK bonds were front-and-centre in the recent reflation-driven sell-off, with gilt yields rising 50 basis points through February. Some of this is undoubtedly down to a reappraisal of growth prospects after a lacklustre post-Brexit period of activity. But it still poses an interesting question - is the UK really set to follow the US with surging inflation, or does it sit more closely with a more benign eurozone story?

When it comes to vaccines at least, the UK remains at the front of the pack. The government has hinted that the rate of inoculations will double over coming weeks, leaving open the possibility of all adults receiving both doses of a vaccine by early in the third quarter.

Combined with the relentless downtrend in case numbers (daily figures have fallen by roughly 90% on the January peak), there's no reason to doubt the UK's planned reopening through April and May, which will see the bulk of sectors reopen. The government hopes to remove the majority of restrictions on social gatherings by mid-June, though the risk is this is pushed back given concerns about new variants.

UK Covid-19 cases are down 90% on the January peak



Source: Macrobond, ING

6% second quarter growth means the BoE won't be in a rush to add more stimulus

It's likely that the reopening will drive 6% growth in GDP through the second quarter, and we think the economy may only be down around 2-3% on pre-Covid levels by year-end. However we should stress the picture has been heavily skewed by the inclusion of the government's Test-and-Trace spending, which on its own saw the level of monthly GDP revised up by around 1-1.5% by the end of 2020. This infrastructure is likely to remain necessary for some time, given the need for accurate intelligence on how the virus is spreading into next winter.

Still, the prospect of a decent spring recovery means the Bank of England has taken a fairly relaxed stance on the rise in yields so far. We also find it hard to see negative rates being enacted later this year assuming the outlook plays out as hoped.

We don't expect the US inflation story to be replicated in the UK

That said, where the UK story differs to the US is on inflation. Much of this comes down to fiscal support, which has arguably seen a greater boost for lower-earners across the Atlantic. While UK savings have risen sharply through the pandemic, lower-income groups have seen the opposite according to surveys - no doubt because the hardest-hit sectors tend to have the lowest wages.

> *While there is likely to be some pent-up demand, it may not have such a lasting impact on UK inflation.*

Indeed, we expect to see a further rise in unemployment over coming months as the furlough scheme is unwound, but also as new Brexit-related costs put pressure on jobs. Consumer confidence surveys aren't yet consistent with households spending all of their newly-accrued savings.

So while there is likely to be some pent-up demand, undoubtedly driving up prices for certain supply-constrained services, it may not have such a lasting impact on UK inflation. Unlike the US, we also haven't seen so much supply erosion. Business closures in the hospitality sector haven't risen above 2.5%, and are heavily concentrated in the smallest businesses, according to ONS surveys.

That may help explain why services inflation hasn't actually slowed that much during the pandemic, outside of restaurants/hotels etc which benefited from a VAT cut. Over time, services prices tend to be much stickier relative to goods in the UK.

> In short, we do expect inflation to reach the 2% target in the fourth quarter, helped mainly by energy, but also some demand/supply imbalances and higher shipping costs. But we think these price pressures will dissipate a little in 2022, reducing pressure on the Bank of England to shift abruptly towards tightening policy.

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