UK rate rises are further off than markets expect

Without more concrete signs of widespread wage growth, the recent surge in electricity prices and subsequent rise in inflation will simply weigh on the cost of living and slow growth this winter. That suggests markets are wrong to price almost three rate hikes by the end of next year. We don't expect the first move from the Bank of England until May 2022

Source: Shutterstock

Higher electricity prices add to a growing mix of growth headwinds

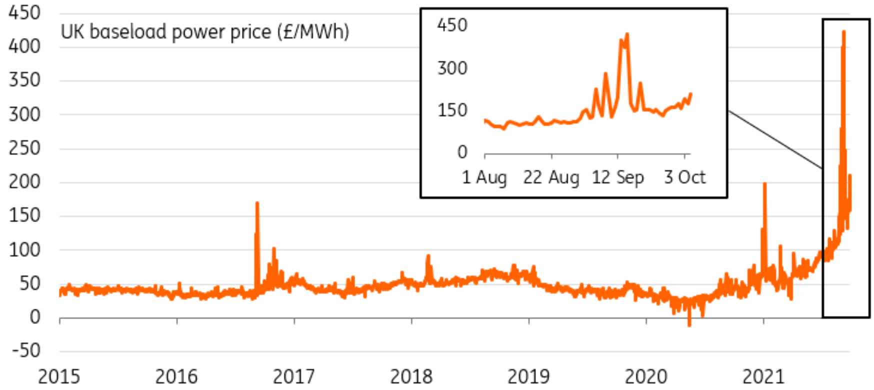
The eyewatering spike in natural gas prices is a particular problem for the UK. Not only is Britain among the most reliant on gas for its power, but it's also been an unrelentingly bad few months for wind generation. Gas stockpiles are also perilously low, and Britain has only 6% of what Italy has in storage – Europe's other big gas-power generator.

The household energy cap is likely to rise by another 20-30% next April, and that's likely to take headline inflation to 4.5% or above. That, and ongoing supply chain pressures, mean headline inflation may now stay above target through all of next year.

Markets have taken this as a signal that the Bank of England is going to have to act earlier – and investors now have almost three hikes priced by the end of 2022, the first by February. To us, this seems too aggressive. And while we are bringing forward our previous BoE call, we're still not expecting the first hike until May 2022, with the second not until 1Q23.

That's mainly because the UK is entering a cost of living crunch, and the impact of higher energy/goods prices are being amplified by tighter fiscal policy. The government has now reversed a £20/week uplift to Universal Credit (welfare) payments, which represents a 5% average income cut for its five-million recipients, according to the Resolution Foundation. That puts the UK at odds with some eurozone governments, which are helping to offset rising household energy bills.

UK power prices are surging



Source: Refinitiv

Concrete signs of wage growth are more important than inflation expectations for the BoE

All of this is likely to weigh on growth this winter. Consumer confidence fell noticeably in September, and the recent petrol issues won't have helped either.

So what would it take for the Bank of England to hike into what is a tricky growth environment?

Inevitably there's much focus on inflation expectations, and Governor Andrew Bailey said recently he's taking this risk 'very seriously'. Certainly, market-based measures are high, and you'd assume household surveys would pick up further, too. But what matters is whether higher inflation now translates into repeated, elevated price rises in the future. That seems unlikely to be a direct consequence of higher energy prices, particularly as we would assume the situation will calm down after this winter – in turn lowering headline inflation into 2023.

Instead, as always, it comes down to wage growth.

Unfortunately, the data here isn't currently that helpful, though the BoE's network of agents believe pay is rising at pre-pandemic rates. There's no doubt that skill-shortage jobs are seeing sharp wage increases. But that's likely coinciding with some increased spare capacity in the jobs market, now the furlough scheme has ended. 2% of workers were estimated to have been 'fully furloughed' to the end, and that's now likely to translate into a modest rise in unemployment and inactivity (eg involuntary early retirement).

The UK is experiencing a mismatch, and what the Bank of England needs to decide is which competing jobs narrative is more prevalent. We're a little more cautious than the Bank, but importantly, policymakers are unlikely to know for sure until late this year. In the meantime, caution is likely to prevail.

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