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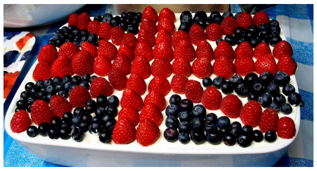


The UK's Trifle with Inflation

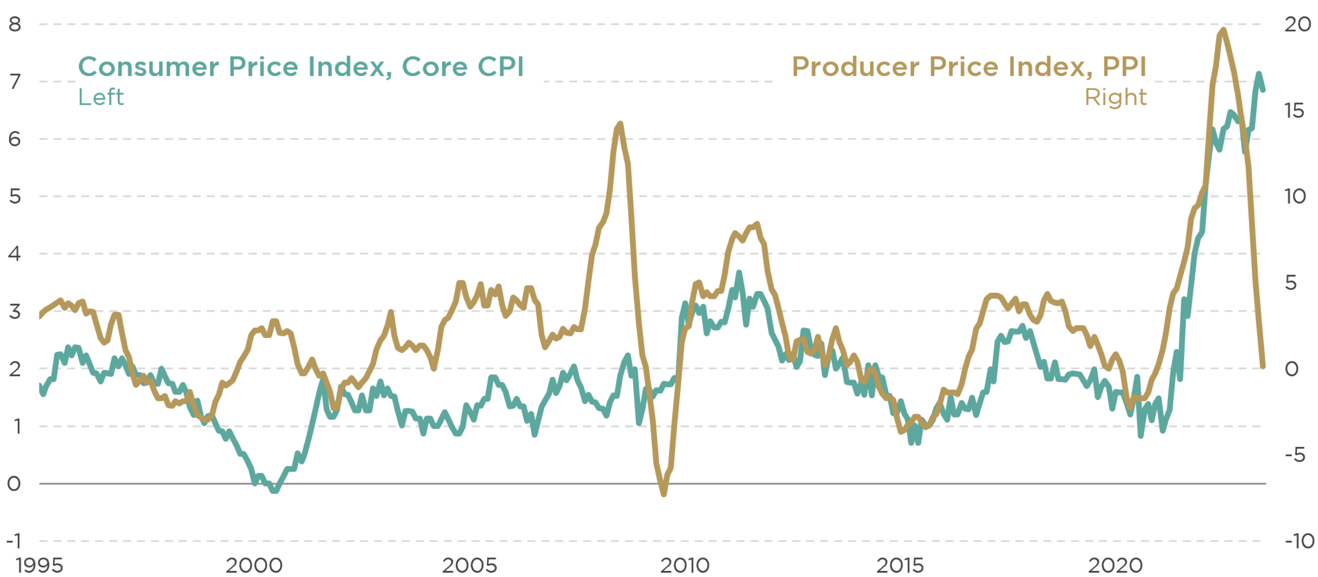
Paul Mielczarski |

June's UK headline inflation data came in better than expected, with the pace falling to a 15-month low, according to the latest report from the Office for National Statistics. However, for the past four months, inflation had consistently come in above expectations. And even with these latest numbers, inflation remains well above the 2% target and significantly higher than in most other G7 countries, leaving the Bank of England (BOE) in a difficult position. Core inflation showed only modest softening, falling to 6.9% from 7.1% (see Exhibit 1). Additionally, food prices, one of the most significant drivers behind UK inflation, remain painfully high (see Exhibit 2). The headline services inflation rate declined slightly to 7.2% from 7.4%, but wage growth accelerated to a record high.

The bright spot in the recent data was a sharp drop in the Producer Price Index (PPI). While there is some uncertainty around further easing in services inflation as wage pressures remain elevated, we expect inflation pressures to continue to ease in the second half of 2023 or even correct sharply on the back of lower food, energy, and core goods inflation. Falling PPI and import prices provide some evidence that core goods inflation should start to moderate. While market expectations for further BOE rate increases may subside, the BOE must still get ahead of the data.

1 | UK Inflation

%, As of 6/1/2023

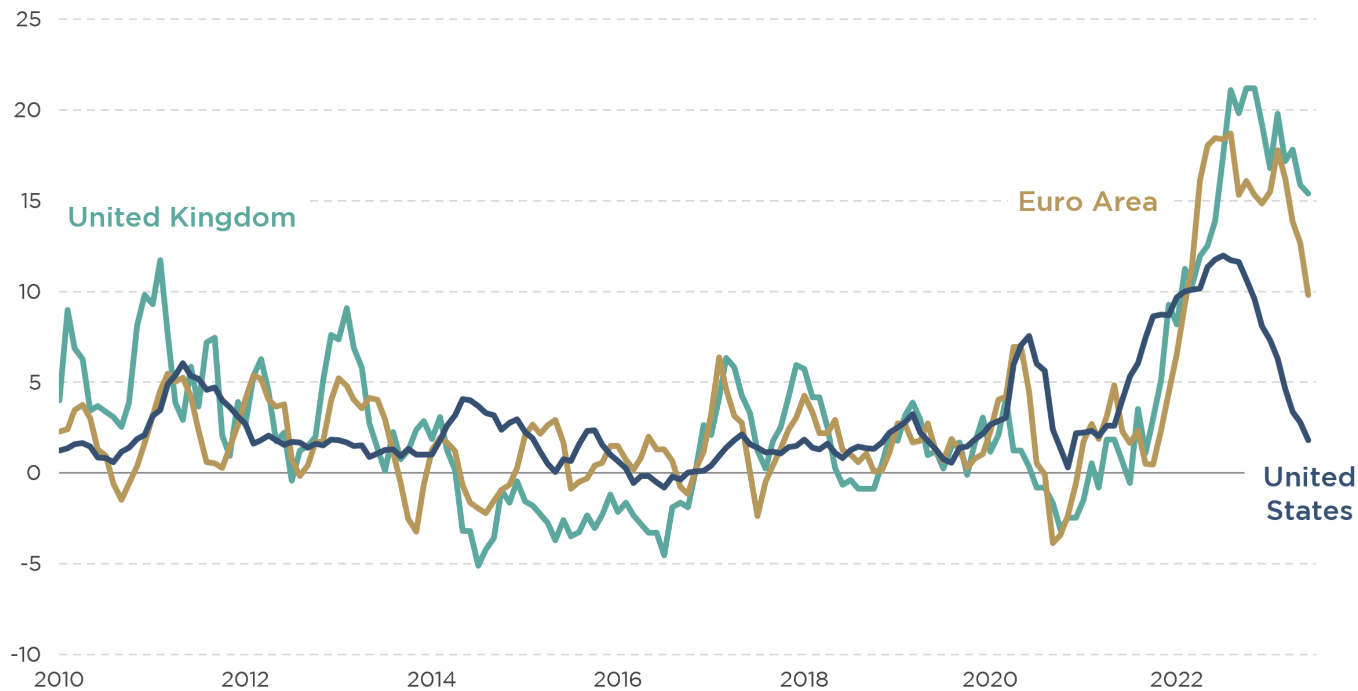


Source: Brandywine Global, Macrobond

2

Food & Beverages Inflation

%, Month-over-Month, 5-Month Moving Average, As of 6/1/2023



Source: Brandywine Global, Macrobond, ONS, Eurostat, BLS

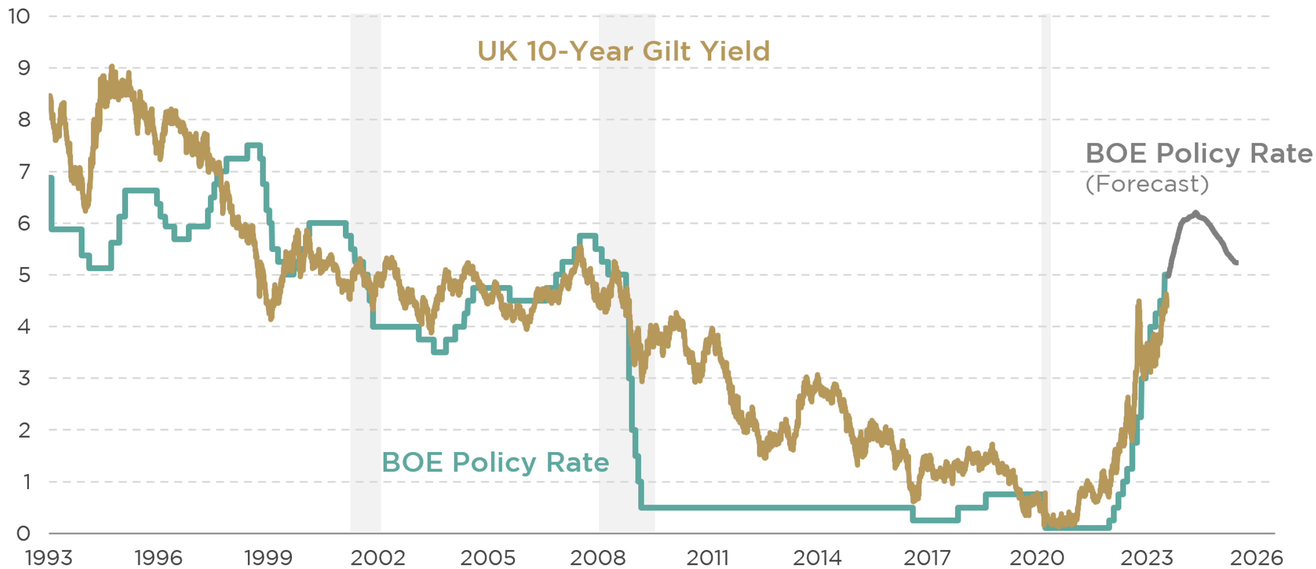
BOE in a Pickle

The crux of the UK's inflation problem has been that the BOE persistently underestimated the strength of inflationary pressures. After a string of upside inflation surprises, the BOE was forced to play a challenging game of catch-up. At its June meeting, the BOE raised the policy rate by 50 basis points to 5.0%, which was its thirteenth consecutive hike. Based on current market pricing, UK monetary policy settings are expected to become even tighter (see Exhibit 3). While the Federal Reserve and other central banks are likely nearing the end of their tightening cycles, the BOE is still facing additional rate hikes. However, because the BOE must continue to act quickly and authoritatively, it also now runs the risk of materially over-tightening.

3

UK Policy Rate vs. 10-Year Gilt Yield

%, Bank of England (BOE) bank rate with SONIA futures as forecast, As of 5/1/2023



Source: Brandywine Global, Macrobond, BOE

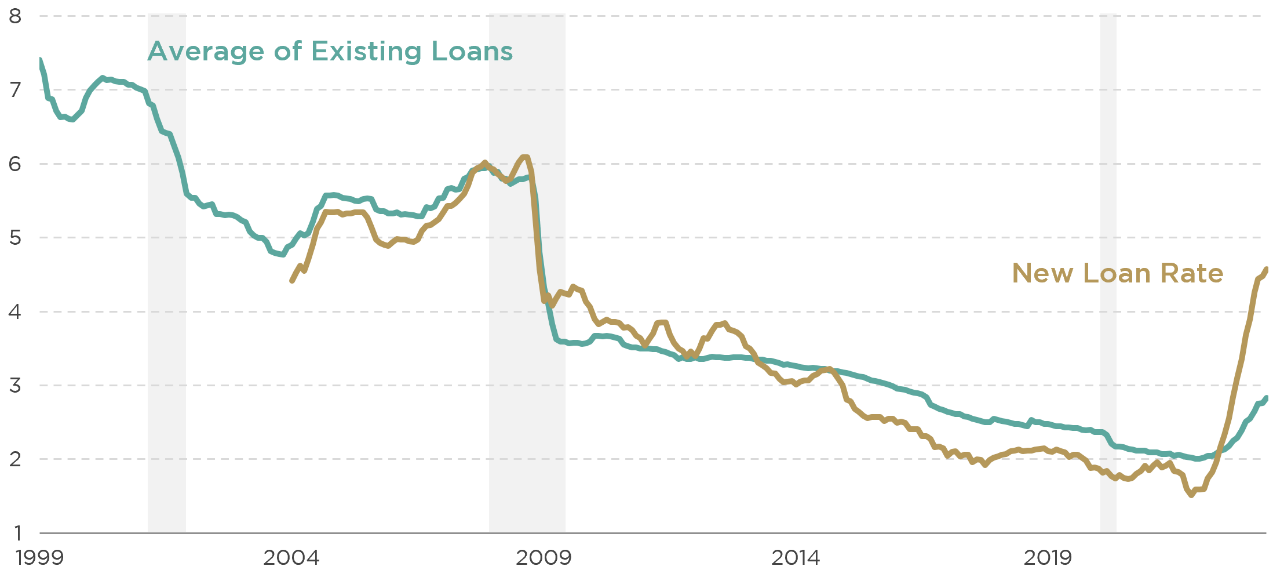
Higher Rates Will Drag on Growth

The pass-through in the UK from policy rates to mortgage rates has been slower this tightening cycle. In recent years, UK homebuyers have moved away from traditional variable rate mortgages to fixed rate loans, locking in low borrowing costs. However, we expect to see an increasing impact of higher policy rates on household mortgage payments going forward (see Exhibit 4). Similarly, most corporate debt in the UK is floating rate, which has a direct pass-through from policy rates to corporate loan costs. So far, business confidence has been quite resilient. But with short rates approaching 20-year highs, we should expect some negative impacts to investment and employment. For both businesses and consumers, increased borrowing costs from higher rates are likely to create a significant drag on consumption.

4

UK Mortgage Interest Rates

%, As of 5/1/2023



Source: Brandywine Global, Macrobond, BOE

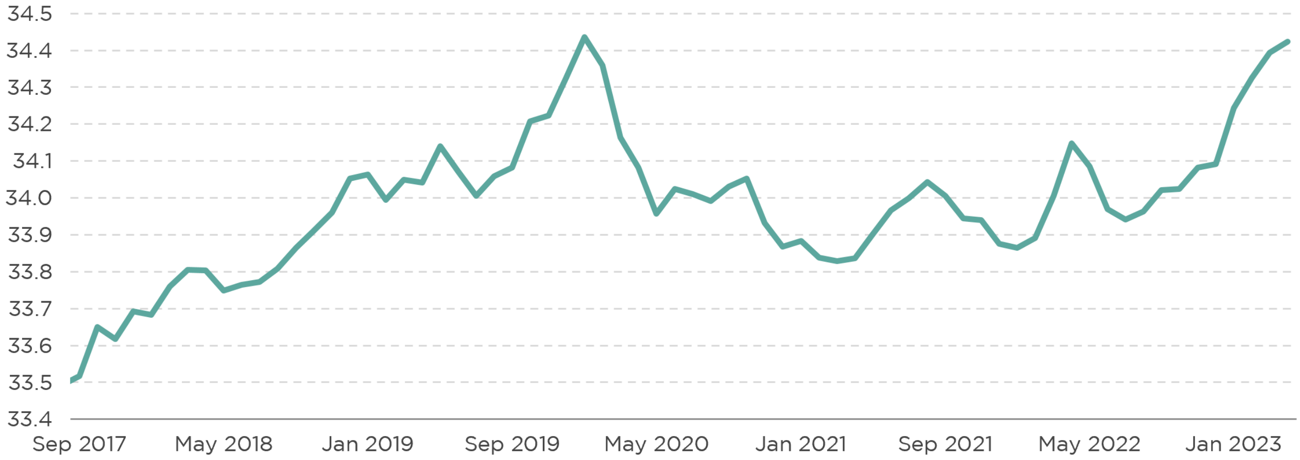
Wage Pressures Likely to Subside

As mentioned above, a drop in services inflation remains contingent on wage pressures, which are elevated. However, it is worth noting that the UK is currently experiencing strong growth in its labor force due to both higher immigration and UK residents returning to the workforce (see Exhibit 5). As a result, the unemployment rate is rising even with healthy growth in labor demand (see Exhibit 6). This rapid labor force increase should ease wage pressures going forward.

5

UK Labor Force Growth

No. of Persons, Millions, All Aged 16 & Over, Seasonally Adjusted, As of 4/1/2023



Source: Brandywine Global, Macrobond

6

UK Unemployment Rate

%, Seasonally Adjusted, As of 4/1/2023

Source: Brandywine Global, Macrobond

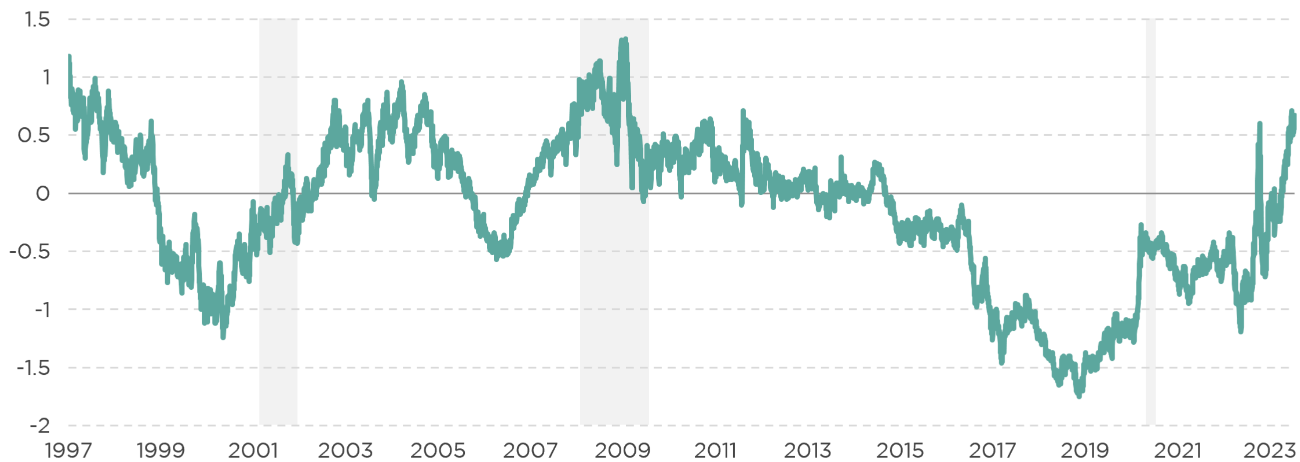
Investment Implications

UK bonds have significantly underperformed both U.S. and eurozone bonds in recent months, with yield spreads now at historically elevated levels (see Exhibit 7 and Exhibit 8).

7

UK-US 10-Year Yield Spread

Basis points, Last: 60 bps, Period Average: -14 bps, As of 7/14/2023



Source: Brandywine Global, Macrobond

8

UK-Euro 10-Year Yield Spread

Basis Points, Last: 177 bps, Period Average: 60 bps, As of 7/14/2023

Source: Brandywine Global, Macrobond

In contrast to the September 2022 gilt market shock, the recent underperformance of UK fixed income has been driven by the market's repricing of BOE terminal rate expectations. With the market expecting additional near-term rate hikes for the UK compared to other G10 countries, the recent repricing has left UK fixed income markets attractive on cross-country basis.

Already attractively valued in our view, gilts could receive a boost in two different scenarios that appear likely to fall into place as the year progresses. The first scenario is inflation comes down sharply in the second half of the year, and the BOE does not need to hike as much as expected. The second is a situation where inflation remains high over the next couple of months, forcing the BOE to hike rates above 6% and the UK economy to hit

a hard landing in 2024. I suspect we see a mix of both as the BOE will feel the need to be aggressive—at least for its next few meetings.

One risk to our outlook is that UK inflation remains high, resulting in a wage-price spiral. A second risk comes from the very large increase in net bond supply at a time when liability driven investors (LDI) are being risk-averse after last September's gilt blow-up. However, we believe it is a matter of time until inflation starts coming down, likely in the second half of 2023, and we see a more significant impact of BOE rate hikes later this year and into early 2024.

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