

VIEW OF ECONOMIC CONDITIONS

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ECONOMICS UPDATE (Quarter to June 2021)

UK. The 24 June Monetary Policy Committee meeting voted unanimously to keep Bank Rate unchanged at 0.10%. They voted by a majority of 8-1 to continue unchanged the existing programme of UK government bond purchases of £875bn which is due to end by the end of this year. In the press release, it was noted that:-

“Since May, developments in global GDP growth have been somewhat stronger than anticipated, particularly in advanced economies. Global price pressures have picked up further, reflecting strong demand for goods, rising commodity prices, supply-side constraints and transportation bottlenecks, and these have started to become apparent in consumer price inflation in some advanced economies. Financial market measures of inflation expectations suggest that the near-term strength in inflation is expected to be transitory”.

The MPC noted the developing upside risks in the UK to both activity and inflation. It said that the news on activity “had predominately been to the upside” and that Bank staff had “revised up their expectations for 2021 Q2 GDP growth to 5½% from 4¼%”. For the first time, the policy statement noted that “there are increasing signs of recruitment difficulties for some businesses” and the minutes said, “it was possible that the near-term upward pressure on prices could prove somewhat larger than expected”. Indeed, by saying that inflation “is likely to exceed 3% for a temporary period” the MPC admitted the Governor will have to write to the Chancellor later this year explaining why inflation is more than 1% above the 2% target.

But the key point is that the MPC still appears willing to ride out the **inevitable spike in inflation** over the next six months as it thinks it will be short-lived and caused by one-off reopening price rises and supply shortages relative to demand - boosted by consumers having built up huge savings of around £145bn during lockdown. These spikes will drop out of the CPI calculation over the next twelve months. The forward guidance in the policy statement designed to demonstrate the MPC's patience was left intact, and the emphasis remained on “the medium-term prospects for inflation” rather than factors that are “likely to be transient”. The minutes said the MPC should “ensure that the recovery was not undermined by a premature tightening in monetary conditions”. It also repeated that it will not raise Bank Rate until the 2% inflation target has been attained sustainably i.e. the mere fact that it is forecasting inflation to be over 2% during 2021 and 2022 is not in itself sufficient to justify an increase in Bank Rate in the near future. The MPC indicated in the minutes that some members would prefer to wait for a clearer picture of the underlying pace of the recovery once the furlough scheme expires at the end of September, before making any judgement on medium-term inflationary pressures. This implies that the MPC may be unlikely to be in a position to consider a change in policy until early in 2022 at the earliest.

In addition, the Bank is undertaking a review of its stated current policy to raise Bank Rate first before **unwinding quantitative easing** (QE) purchases of gilts. Indeed, it now appears to be likely that the Bank could unwind QE first before raising Bank Rate as it sees QE as a very useful quick acting weapon to use to combat any sudden dysfunction in financial markets, as happened in March 2020. However, it is currently nearly maxed out on the total level of QE. Unwinding QE first would cause short term gilt yields to remain anchored at low levels and medium and long term gilt yields to steepen. Money markets are currently expecting Bank Rate to start rising in mid-2022 but they are probably being too heavily influenced by looking across the Atlantic where inflationary pressures are much stronger than in the UK and building up further under a major boost from huge Federal government stimulus packages. Overall, there could be only a minimal increase in **Bank Rate** in 2023 or possibly no increases before 2024.

GDP. The Bank revised up its expectations for the level of UK GDP in 2021 Q2 by around 1½% since the May Report due to the easing of restrictions on economic activity; this now leaves total GDP in June only around 2½% below its pre-Covid 2019 Q4 level. UK GDP grew by 1.5% in the three months to April 2021: this was the first expansion since the three months to December 2020. Forward looking monthly business surveys are running at exceptionally high levels indicating that we are heading into a strong economic recovery. Capital Economics do not think that the UK economy will suffer major scarring from the lockdowns. The one month delay to the final easing of restrictions in July is unlikely to have much effect on the progress of recovery with GDP getting back to pre-Covid levels during August.

CPI. The annual inflation rate in the United Kingdom rose to 2.1% y/y in May from 1.5% y/y in April: this is the first time that the measure has been above the Bank of England's 2% target since July 2019.

COVID-19 vaccines. These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the second half of 2021** after a third wave of the virus threatened to overwhelm hospitals in Q1 this year. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The UK has made fast progress, giving both jabs to nearly half of the total population and one jab to two thirds, (84% of all adults). This programme should be completed in the second half of the year. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

US. Since the Democrats won the elections in late 2020 and gained control of both Congress and the Senate, (although power is more limited in the latter), they have passed a \$1.9trn (8.8% of GDP) stimulus package in March 2021 on top of the \$900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also now negotiating to pass a \$1trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation had actually been under-shooting the 2% target significantly for most of the last decade, so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after that meeting. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow by allowing inflation to run higher for longer, even if they do not call it a policy of average inflation targeting as such.

In the **Fed's June meeting**, it stuck to its line that it expects strong economic growth this year to have only a transitory impact on inflation which is being temporarily boosted by base effects, spikes in reopening inflation and supply shortages. The big surprise was the extent of the upward shift in the "dot plot" of interest rate projections: having previously expected no hikes until 2024 at the earliest, most officials now anticipate two in 2023, with 7 out of 18 expecting to raise rates next year. This was a first indication that there was rising concern about the risks around inflationary pressures building up on a more ongoing basis and is somewhat hard to reconcile to the words around inflation pressures being only transitory.

Treasury yields in the US ought to rise much more strongly than gilt yields in the UK due to the divergence in the levels of inflationary pressures and the levels of surplus capacity currently in both economies, (the US is much nearer full capacity than the UK). Bond investor sentiment could lean in the direction that even if central banks refrain from raising central rates in the short term, all they are doing is setting up sharper increases further down the line. This is likely to cause increases in longer-term bond yields without any actual increases in central rates. There will then be a question as to how strong an influence rising treasury yields will have on gilt yields. Due to the divergence between the US and UK economies, it is expected that the Fed rate will need to increase first before Bank Rate and that there could be a significant delay before the Bank of England follows suit.

EU. Both the roll out and take up of vaccines was disappointingly slow in the EU in the first few months of 2021 but has since been rapidly catching up. This delay will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 of 2020 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. After contracting by another 0.3% in Q1 of 2021, recovery will now be delayed until Q3 of 2021. At its June meeting, the ECB forecast strong economic recovery with growth of 4.6% and 4.7% in 2021 and 2022 respectively.

Inflation is likely to rise sharply to around 2.5% during 2021 for a short period, but as this will be transitory, due to one-off factors, it will cause the ECB little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it

retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE, which started in March 2020, is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, **unlikely to be a euro crisis** while the ECB maintains this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases. Meetings in April and June confirmed these policies so monetary policy will remain highly accommodative with no sign yet of tapering of asset purchases.

China. After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of 2020; this enabled China to recover all the contraction in Q1 2021. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. After making a rapid recovery in 2020/21, growth is likely to be tepid in 2021/22.

Japan. A third round of fiscal stimulus in December 2020 took total fresh fiscal spending in 2020 in response to the virus close to 12% of pre-virus GDP. That is huge by past standards, and one of the largest national fiscal responses. The resurgence of Covid in Q1 2021, coupled with a slow roll out of vaccines, has pushed back economic recovery. However, quickening of vaccinations in the second half of 2021 will lead to a strong economic recovery to get back to pre-virus levels by the end of 2021 – around the same time as the US and sooner than the Eurozone.

World growth. World growth was in recession in 2020 but should recover during 2021. Inflation is unlikely to be a significant problem in most countries for some years due to the creation of excess production capacity and depressed demand during the coronavirus crisis.

Impact on gilt yields and PwLB rates in 2021. Since the start of 2021 gilt yields and PwLB rates have risen sharply. What has unsettled financial markets has been a \$1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic, in addition to the \$900bn support package passed in December. Financial markets have been concerned that the two packages, on top of the Fed already stimulating the economy by cutting the Fed rate to near zero and unleashing massive QE, could cause an excess of demand in the economy which **unleashes strong inflationary pressures**; these could then force the FOMC to take much earlier action to start increasing the Fed rate from near zero, despite their stated policy being to target average inflation and saying that increases were unlikely in the next few years.

A further concern in financial markets is **when will the Fed end quantitative easing (QE) purchases of treasuries** and how they will gradually wind it down. These ongoing monthly purchases are currently acting as downward pressure on treasury yields. Nonetheless, during late February and in March, yields rose sharply. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards there will invariably impact and influence financial markets in other countries. It is noticeable that gilt yields moved higher after the MPC meeting in early February as a result of both developments in the US, and financial markets also expecting a **similarly rapid recovery of the UK economy as in the US**; both countries were expected to make similarly rapid progress with vaccinating their citizens and easing Covid restrictions. They are, therefore, expecting inflation to also increase more quickly in the UK and cause the MPC to respond by raising Bank Rate more quickly than had previously been expected.

Deglobalisation. Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China which caused considerable consternation in western countries. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is, therefore, likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China to supply products and vice versa. This is likely to reduce world growth rates from rates in prior decades.

Central banks' monetary policy. During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is, therefore, very important that bond yields stay low while debt to

GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. The Fed has changed its policy on inflation to targeting an average level of inflation. Greater emphasis will also be placed on hitting subsidiary targets e.g. full employment, before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.