

Commentary by Link Asset Services on the Economy, & Interest Rates

- The first quarter of 2024/25 saw:
 - GDP growth flatlining in April following positive Q4 2023/24 growth figures of 0.7% q/q.
 - A stalling in the downward trend in wage growth, with the headline 3myy rate staying at 5.9% in April.
 - CPI inflation falling from 2.3% in April to 2.0% in May.
 - Core CPI inflation decreasing from 3.9% in April to 3.5% in May.
 - The Bank of England holding rates at 5.25% in May and June.
 - 10-year gilt yields climbing to 4.35% in April, before closing out at 4.32% in May.
- The news that the economy grew by 0.7% q/q in Q4 2023/24 confirmed that it moved out of its very mild technical recession that prevailed at the back end of 2023. However, data released for April and May so far shows a slight stalling in the recovery, with GDP data for April coming out at 0.0% m/m, as inclement weather weighed on activity. Moreover, the fall in the composite Purchasing Manager Index output balance from 53.0 in May to 51.7 in June confirms tepid growth.
- On a more positive note, the 2.9% m/m increase in retail sales volumes in May more than reversed the 1.8% m/m drop in April as rainfall returned to seasonal norms. The strength was broad-based across the retail sector, including online, (+5.9% m/m) suggesting an underlying strengthening in sales beyond weather effects. With inflation falling back to target, Bank Rate likely to be reduced soon and with consumer confidence improving, retail sales may well continue to strengthen.
- Stronger consumer spending, as low inflation allows households' real incomes to strengthen and the drag from higher interest costs fades, suggests that real consumption will strengthen substantially over the next two years. However, investment will only make a modest contribution to GDP growth. With the industrial sector still 12% smaller than in 2019, excess capacity will continue to cap the need for industrial firms to invest. But improving business sentiment should raise investment by services' firms. Further, a fall in mortgage rates should trigger a recovery in residential investment. Overall, strong consumer spending is likely to be the backbone of GDP growth, along with government consumption. Our colleagues at Capital Economics forecast that following GDP growth of 1.0% in 2024, activity will continue to surprise to the upside with GDP growth of 1.5% for both 2025 and 2026 (consensus forecasts are 1.2% and 1.4% respectively).
- Nonetheless, the on-going stickiness of wage growth in April will be a lingering concern for the Bank of England. The 3myy rate of average earnings growth stayed at 5.9% in April (consensus 5.7%), whilst the more timely 3m annualised rate rebounded from 5.9% to 9.3%. This stickiness partly reflected April's 9.8% increase in the minimum wage. This leaves the Bank of England's forecast for a fall back in regular private sector pay growth from 5.8% in April to 5.1% in June looking a challenge.
- Despite the stickiness of wage growth in April, sharp falls in employment and a move up in unemployment suggests that wage growth will soon be back on a downward path. The 139,000 fall in employment in the three months to April was accompanied by a rise in the unemployment rate from 4.3% to 4.4%. This was the fourth increase in a row and took it to its highest level since September 2021. The rise would have been larger were it not for the 132,000 increase in inactivity in the three months to April as the UK's disappointing labour market participation performance since the pandemic continued. The vacancies data also paint a picture of a slowly cooling labour market. The number of job vacancies fell from an upwardly revised 908,000 to 904,000, leaving vacancies 31% below the peak in May 2022, but 11% above the pre-pandemic level.
- The fall in CPI inflation in May back to the Bank's 2% target for the first time since July 2021 will have come as welcome news to the Bank. Furthermore, with CPI inflation of 3.3% in the US and 2.6% in the Euro-zone in May, the UK appears to have won the race to get CPI inflation back to 2.0%. A further easing in food inflation from 2.8% in April to 1.6% in May played a part in the fall in overall CPI inflation and with food producer price inflation at just 0.2% in May, food price inflation will probably soon fall to zero.
- The core rate also fell back from 3.9% to 3.5%. Within that, core goods CPI inflation slipped below zero for the first time since October 2016. As expected, clothing/footwear, recreation/culture and restaurants/hotels categories inflation declined, reflecting base effects from big increases last May. While services inflation fell from 5.9% to 5.7%, this decline was smaller than the Bank of England expected (forecast 5.3%). And the timelier three-month annualised rate of services prices has rebounded from 8.5% to 9.2%. This suggests that the persistence in domestic inflation that the Bank is worried about is fading more slowly than it thought. Even so, there is scope for inflation to fall further.

- There was little chance that the Bank would cut rates at its June meeting, given upside surprises on services CPI inflation and wage growth. But several developments implied a rate cut is getting closer (August?). First, two members of the MPC, Ramsden and Dhingra voted again to reduce rates immediately to 5.00%. Second, despite the recent run of stronger inflation and activity, the minutes noted “indicators of inflation persistence had continued to moderate” and that a range of indicators suggest pay growth had continued to ease. And there was new wording that members of the MPC will consider all the information available and how this affects the assessment that the risks from inflation persistence are receding “as part of the August forecast round”.
- Throughout the quarter there was a degree of volatility in the gilt market and, by way of example, the 10-year gilt yield rose from 4.05% on 2nd April to finish at 4.15% on 28th June but it has exceeded 4.30% on several occasions. Overall, investors judged that interest rates will need to remain high for longer to keep inflation around the 2.0% target.
- Meanwhile, the FTSE 100 broke through the 8,000 mark in April for the first time since its brief three-day flutter in February last year and reached a record closing high of 8,446 on 15th May. However, by the end of the quarter, despite AI-fuelled rises in the US S&P500, it finished rather tamely and had fallen back to 8,164. Arguably, significant interest rate cuts and an on-going UK economic recovery will be required for a further resurgence to take hold.

MPC meetings 9th May and 20th June 2024

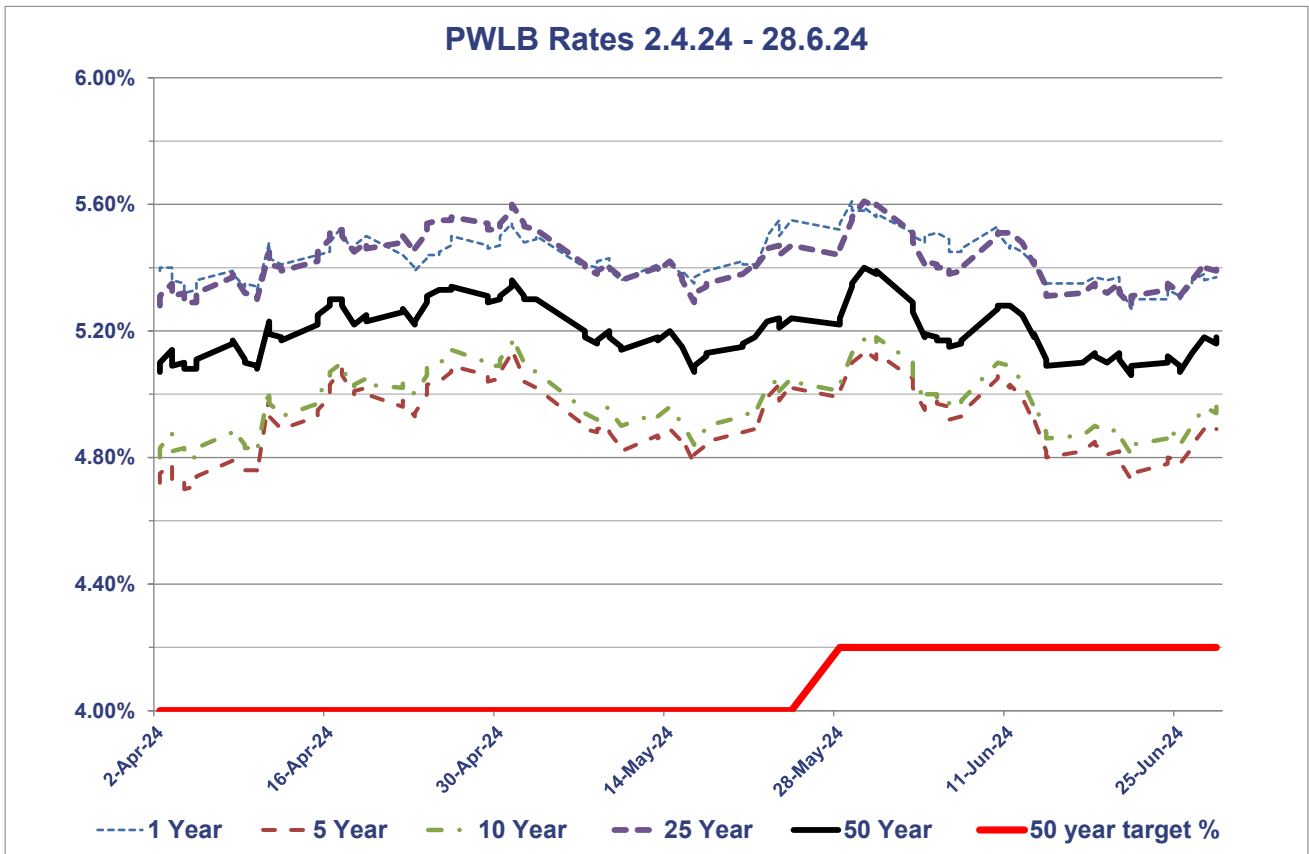
- On 9th May, the Bank of England’s Monetary Policy Committee (MPC) voted 7-2 to keep Bank Rate at 5.25%. This outcome was repeated on 20th June.
- Nonetheless, with UK CPI inflation now back at 2% and set to fall further over the coming months, Ramsden and Dhingra – who voted again to reduce rates immediately to 5.00% in June – may shortly be joined by some members in the no-change camp, for whom the June decision was “finely balanced” as the upside news on services price inflation was more likely to be a reflection of one-off effects and volatile components rather than factors that would push up “medium-term inflation”.

PWLB maturity Certainty Rates 1st April to 30th June 2024

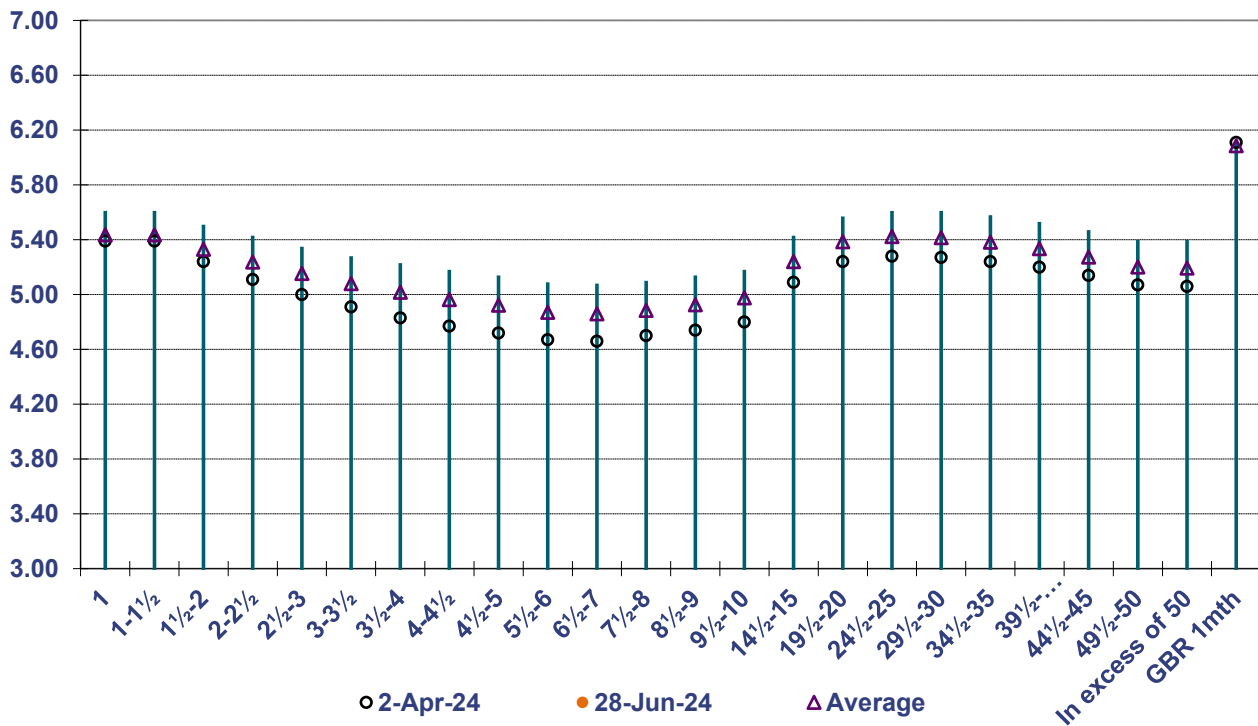
Gilt yields and PWLB rates remained relatively stable between 1st April and 30th June. Having said that, the spread between the low and high points during the quarter was between 0.3% and 0.45% across the curve.

The 50-year PWLB Certainty Rate target for new long-term borrowing (the low point of our forecast on a two-year timeline) started 2024/25 at 4.00% and increased to 4.20% on 28th May. As can be seen, with rates remaining elevated across the whole of the curve, it is advised to not borrow long-term unless the Authority wants certainty of rate and judges the cost to be affordable.

PWLB RATES 02.04.24 - 28.06.24 (note: the 1st April & 29th and 30th June were bank holidays/weekends)



PWLB Certainty Rate Variations 2.4.24 to 28.6.24



HIGH/LOW/AVERAGE PWLB RATES FOR 02.04.24 – 28.06.24

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	5.27%	4.70%	4.80%	5.28%	5.06%
Date	21/06/2024	04/04/2024	02/04/2024	02/04/2024	21/06/2024
High	5.61%	5.14%	5.18%	5.61%	5.40%
Date	29/05/2024	01/05/2024	01/05/2024	30/05/2024	30/05/2024
Average	5.43%	4.92%	4.98%	5.42%	5.20%
Spread	0.34%	0.44%	0.38%	0.33%	0.34%