BEA 東亞銀行

Economic Research

October 2021

Market Monitor – United Kingdom

Tax Hike Spurs Worries over Recovery Trajectory

UK sees monthly GDP growth stall amid supply chain constraints and labour shortage.

Tax hikes scheduled to be effective next April may impact the jobs market.

Bond yields surge as expectation of earlier rate hike by BoE intensifies.

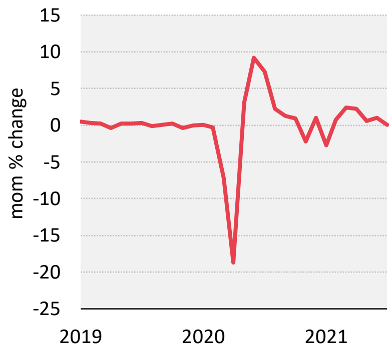
UK GDP growth stalls in July amid supply chain bottlenecks and a labour shortage

In July, Britain's economy saw the weakest monthly growth since January. GDP only grew 0.1% from June, amid surging numbers of confirmed Covid-19 cases and lingering supply chain bottlenecks. At the same time, shortages of labour have been affecting firms' business operations, especially in the logistics sector. The food industry body has warned that a lack of large goods vehicle drivers may result in ongoing food shortages in the UK. High frequency data also showed that the UK's economic recovery might be losing steam, with the manufacturing PMI further sliding to 57.1 in September from 60.3 in August in final reading. Despite services PMI slightly rebounding to 55.4 in September from the six-month low (55.0) in August, the rate of expansion was still weaker than that during May to July.

UK inflation accelerated again in August, with a yearly growth of 3.2% in the headline consumer price index (CPI), which is a 9-year high. The faster growth in CPI during the month mainly reflects a one-off impact from the "Eat Out to Help Out" scheme that pushed down the prices of restaurant meals last year.

Although Bank of England (BoE) kept interest rates at the current level and maintained its asset purchase programme at its September meeting, market expectation of seeing rate hike in 2022 intensified, as officials of the BoE expected the inflation to slightly stay above 4% into Q2 2022.

GDP



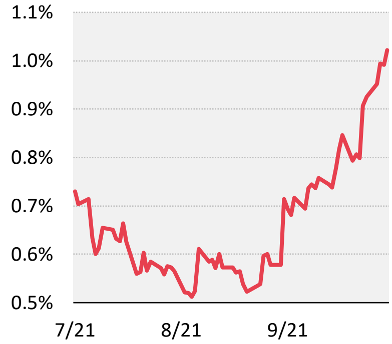
Source: Bloomberg, data as of 30/9/2021

Boris Johnson raises taxes to cover health and social care expenses

Prime minister Boris Johnson won a House of Commons vote for his tax hike proposal. The rate of National Insurance contribution paid by both workers and employers will rise by 1.25 percentage points, with the same increase also applying to a tax on shareholder dividends. The hike is expected to raise GBP 12 billion a year, which will go into the UK's social care system, whose costs are projected to double over the next two decades due to an aging population. It will also be used to tackle a backlog in the state-run National Health Service created by the Covid-19 pandemic.

Looking forward, the UK economy is expected to continue to see solid recovery in Q3 and Q4 2021 as most of lockdown measures have been lifted, with the market expectation being that GDP growth will average 7.6% for the full year of 2021, while inflation is estimated to edge higher at over 3% in Q4 and average 2.2% for the whole year. However, the recent spread of the Delta variant may pose uncertainties for the rebound of the UK economy. Besides this, the increase in national insurance contributions and the tax on dividend income from next April may increase costs for companies, especially small businesses, and thus pose risks to job creation in the long run. In addition, the post-Brexit relationship with the EU will also have an impact on the UK economy, as British companies may see more restrictions on operating in EU countries if tensions between the UK and EU grow.

UK 10-year Government Bond Yield

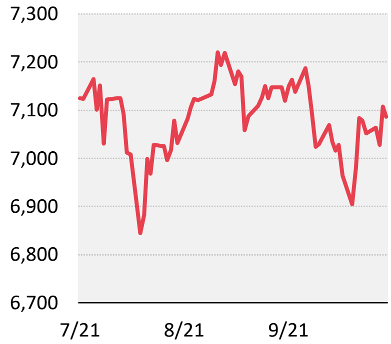


Source: Bloomberg, data as of 30/9/2021

Expectation of early rate hike pushes up bond yields

Investors strengthened expectation that the BoE may raise interest rate next year, as the central bank slightly raise inflation projection at its latest meeting, fuelling a rise in bond yields. At the same time, UK chancellor Rishi Sunak reportedly plans to set out new fiscal rules to rein in government borrowing in October's autumn 2021 budget, causing the yield for 10-year UK government bonds to surge in September. As of 30th September, the 10-year government bond yield stood at 1.022%, about 31 basis points higher than the level at the end of August.

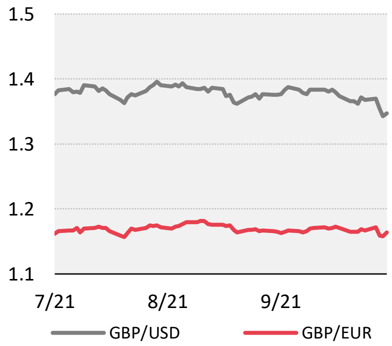
FTSE 100 Index



Source: Bloomberg, data as of 30/9/2021

Meanwhile, uncertainties about the economic outlook stemming from the spread of the Delta variant and persistent worries over inflation also resulted in a pullback in the equity market. As of 30th September, the FTSE 100 Index had declined by 0.5% from the level at the end of August.

British Pound Exchange Rate



Source: Bloomberg, data as of 30/9/2021

In the foreign exchange market, the pound saw a divergent performance. As the US Federal Reserve has signalled an imminent tapering off of asset purchases at its September's meeting and more officials expect to see earlier rate hike, the US dollar strengthened. As of 30th September, the pound had depreciated against US dollar by 2.0% when compared with the level as of August. But the pound only depreciated against euro by 0.1% over the same horizon.

Looking ahead, the UK's equity market will continue to be impacted by the policy stance of the BoE and the UK government, as well as the recovery trajectory of the UK economy. The trend of government bond yields and the pound will also be impacted by the risk appetite of investors as well as by economic fundamentals.

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