BEA 東亞銀行

Economic Research **April 2022**

Market Monitor – United Kingdom

Higher Inflation Still Expected Amid Geopolitical Risk

UK GDP rises faster at start of 2022 as impact from Omicron starts to ease

The UK economy picked up at the start of 2022, with the impact of Omicron starting to ease. GDP rose by 0.8% month on month in January and was 0.8% above its pre-pandemic level, following a 0.2% drop in December 2021. Monthly GDP growth was mainly driven by a 0.8% growth in the services sector, while the construction sector grew by 1.1% and the manufacturing sector also recorded 0.8% growth during the month. The consumer-facing services sector saw a strong rebound in January, with a monthly growth of 1.7%, mainly driven by a 6.8% growth in food and beverage service activity and a 1.9% growth in retail trade.

The UK labour market has seen continued improvement despite the spread of the Omicron variant. The unemployment rate fell to 3.9% in the three months to January, down from 4.1% in the three months to December. At the same time, UK inflationary pressure further intensified in February and hit a 30-year high. The headline consumer price index (CPI) rose 6.2% year on year in February, following a 5.5% rise in the previous month. Core CPI also registered 5.2% growth during the month, up from 4.4% growth in the previous month. As inflationary pressure increases and the crisis in Ukraine intensifies expectations that inflation may continue for longer, consumer confidence is being negatively impacted, with the GfK Consumer Confidence Index falling to -31 in March, down from -26 in the previous month.

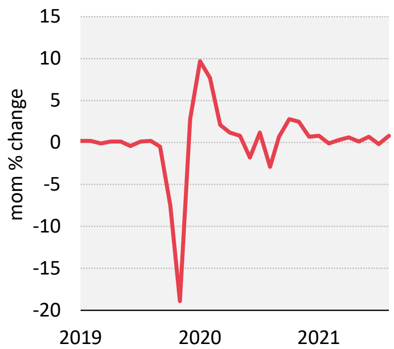
The Bank of England (BoE) raised the bank rate to 0.75% as expected at its March meeting. In contrast to the February meeting, none of the Monetary Policy Committee (MPC) member voted for a 50-basis point hike at the March meeting, and one member voted to keep interest rates on hold. The BoE also noted in its policy summary the additional pressure on inflation caused by Russia's invasion of Ukraine, and now expects inflation to peak at about 8% in Q2 2022. At its February meeting, the BoE had expected inflation to peak at about 7.25% in April. Moreover, the BoE also said that some further modest tightening in monetary policy may be appropriate in the coming months, but noted that there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve.

UK economy grows faster in January 2022 with monthly growth of 0.8%.

Labour market remains resilient, with unemployment rate edging down to 3.9% in the three months to January.

BoE raises interest rate to 0.75% as expected at March meeting.

GDP



Source: Bloomberg, data as of 18/3/2022

Conflict in Ukraine clouds medium-term outlook for the UK

Looking ahead, with the UK government scrapping all remaining Covid-19 travel restrictions on 18th March, the UK's services sector is expected to see further improvement in sentiment in the months ahead. Nonetheless, the risk of a prolonged conflict in Ukraine may pose uncertainties for the ongoing recovery. After Russia's invasion, the UK government joined the US in imposing sanctions on Russia, including a phasing out of Russian oil imports by the end of 2022. Although Russian oil imports only account for 8% of UK's oil demand, the surge of international energy prices due to the disruption resulting from the invasion will still translate into higher local energy prices in the UK.

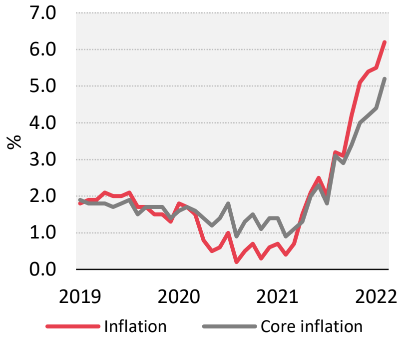
In early February, the UK government announced a package of measures to reduce some of the effect of higher energy bills, including a one-off GBP 150 council tax rebate to 80% of households in April and a GBP 200 reduction in energy bills this autumn for all households. Besides, Chancellor Rishi Sunak announced a 5-pence cut in fuel duty per litre for the next 12 months and to raise the threshold at which workers start paying national insurance by GBP 3,000 in spring statement. He also promised to cut the basic rate of income tax by 1 percentage point in 2024. However, the reduction in energy bills will be repaid over the following five years and household disposable incomes are set to be squeezed with the rise in National Insurance contributions and dividend tax rates. Together with the on-going interest rate hikes and policy normalisation by the BoE, the tightened financial conditions may negatively impact household consumption and business investment, posing a risk of slower GDP growth in the medium term.

Equity market sees increased volatility and pound weakens amid risk-off sentiment

The UK equity market saw volatile movement in March as Russia's war in Ukraine developed. On 7th March, the FTSE 100 Index closed 6.7% lower than the level at the end of February. However, as Russia said that it would reduce military activity around Kyiv after rounds of talks with Ukraine, the FTSE 100 Index rebounded and offset losses. As of 31st March, the FTSE 100 Index had rose by about 0.8% from the level at the end of February.

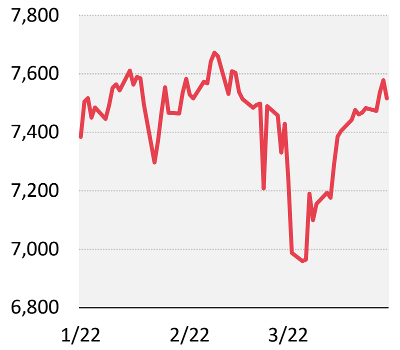
In the bond market, yields continued to rise in March as inflation is expected to remain elevated and general market expectation is that there will be another rate hike in May. As of 31st March, the 10-year government bond yield stood at 1.61%, about 20 basis points higher than the level at the end of February.

UK Inflation



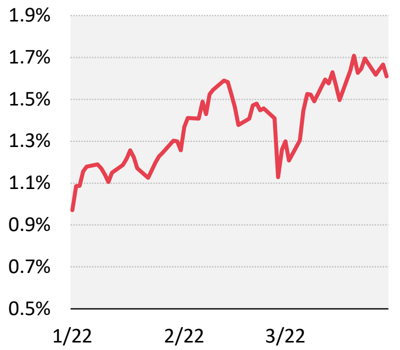
Source: Bloomberg, data as of 28/3/2022

FTSE 100 Index



Source: Bloomberg, data as of 31/3/2022

UK 10-year Government Bond Yield

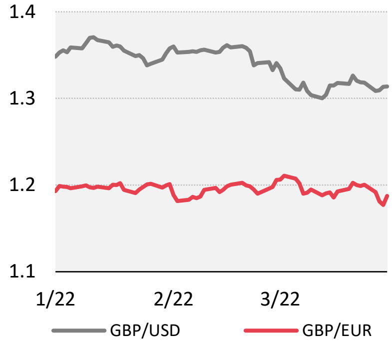


Source: Bloomberg, data as of 31/3/2022

In the foreign exchange market, the pound weakened against the US dollar and the euro as the BoE seemed cautious about the outlook amid the ongoing conflict in Ukraine. Between the end of February and March, the pound depreciated against the dollar by about 2.1%, and against the euro by about 0.7%.

Going forward, as supply chain disruption and high energy prices may persist for longer after the Ukraine conflict, higher inflation may extend to the second half of 2022. Amid the risk of escalating tensions with Russia, the UK financial markets may continue to see higher volatility in the months ahead.

British Pound Exchange Rate



Source: Bloomberg, data as of 31/3/2022

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