BEA 東亞銀行

Economic Research

May 2022

Market Monitor – United Kingdom

Headwinds Mount Amid Persistent Inflationary Pressure

UK economic growth slowed in February mainly due to contraction in the manufacturing and construction sectors

Despite the government having started to ease Plan B restrictions in late January and the services sector continuing to see growth, month-on-month growth of UK GDP slowed sharply in February, mainly because gains in the services sector were partly offset by a contraction in manufacturing and construction. UK GDP grew by 0.1% month on month in February, down from 0.8% growth in the previous month. The services sector saw a monthly growth of 0.2% in February, mainly driven by an increase in tourism-related activity after the easing of Covid-19 restrictions. Nonetheless, the manufacturing sector registered a monthly contraction of 0.4% in February, mainly due to the continued drop in car production. At the same time, the construction sector also dropped by 0.1% month on month.

The UK labour market, on the other hand, continued to improve, with unemployment dropping further to 3.8% in the three months to February, finally matching the pre-pandemic level. Average weekly earnings (including bonuses) also saw year-on-year growth of 5.4% in the three months to February, up from 5.0% growth in the three months to January. Meanwhile, inflationary pressure continued to mount, with the consumer price index (CPI) registering year-on-year growth of 7% in March, up from 6.2% growth in February and now the highest since March 1992. Headline inflation was mainly driven by fuel prices. The core CPI also recorded year-on-year growth of 5.7%. The squeeze on household incomes due to higher inflation continues to dent consumer confidence, with the GfK Consumer Confidence Index falling to -38 in April, down from -31 in the previous month.

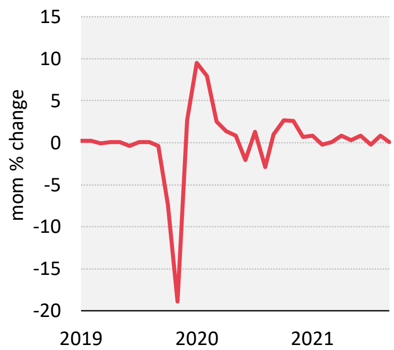
A robust labour market and higher inflation gives the Bank of England (BoE) room to raise interest rates further. At its latest meeting in May, the BoE raised the bank rate to 1% as expected. Three of the nine Monetary Policy Committee (MPC) members voted for a 50-basis-point increase to 1.25%. At previous meetings, the committee reaffirmed that they would consider beginning the process of selling UK government bonds held in the Asset Purchase Facility when the bank rate reached 1%. However, the committee decided not

UK economy grows more slowly in February 2022, although Covid-19 restrictions have been eased since late-January.

Labour market improves further, with the unemployment rate edging down to 3.8% in the three months to February.

Inflation accelerates further, with the CPI registering a 7% year-on-year rise in March.

GDP



Source: Bloomberg, data as of 20/4/2022

to start sales assets but preferred to work on a strategy for UK government bond sales at May's meeting, and would provide an update at its August meeting. In addition, the BoE also warns of risk of economic contraction in Q4 2022 as inflation is projected to peak at slightly over 10% in during the quarter due to higher energy prices.

Looking ahead, as the risk of a prolonged Russia-Ukraine war mounts, in addition to the volatile course of the Covid-19 pandemic, we may see prolonged supply chain bottlenecks, and inflation is expected to remain elevated for longer than previously estimated. The BoE may need to normalise monetary policy at a faster pace to curb inflation. This will result in higher borrowing costs for households and corporations, potentially acting as a drag on economic growth in the medium term.

Benchmark equity index extends gains and bond yields edge higher, while pound sees divergent performance in Forex market

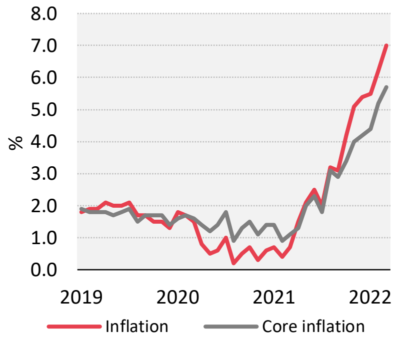
Despite market participants expecting further rate hikes by the BoE, the FTSE 100 Index continued to see gains in April, mainly supported by the improved earnings outlook of oil and mining companies amid elevated commodity prices. As of 29th April, the FTSE 100 index was 0.4% higher than the level at the end of March.

UK government bond yields have been edging higher, as investors expect the BoE to continue raising interest rates at its upcoming meetings. As of 29th April, the 10-year UK government bond yield stood at 1.905%, about 30 basis points higher than the level at the end of March.

In the foreign exchange market, the pound strengthened against the euro but continued to weaken against the US dollar, mainly due to the difference in the pace of policy normalisation by the European Central Bank and the Federal Reserve. As of 29th April, the pound had strengthened against the euro by about 0.4% when compared to the level at the end of March. However, the pound had weakened against the US dollar by 4.3% over the same horizon.

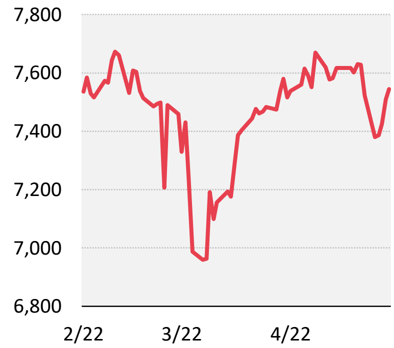
Going forward, the performance of the UK's equity market will hinge on the earnings outlook of companies amid tightened financial conditions and higher inflation. The movement of bond yields and the pound will be influenced by the BoE's pace of policy tightening and by investors' changing risk appetite.

UK Inflation



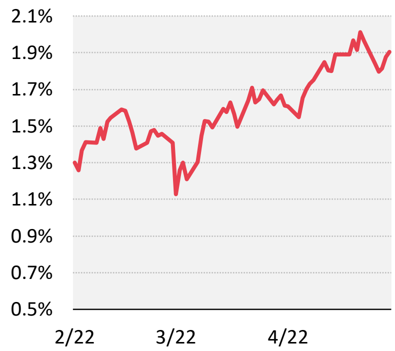
Source: Bloomberg, data as of 20/4/2022

FTSE 100 Index



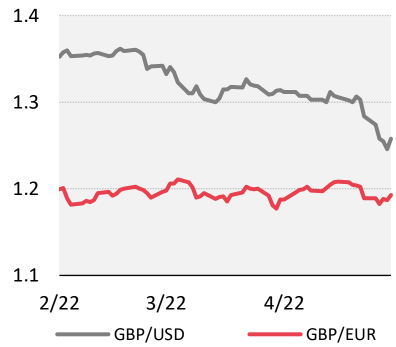
Source: Bloomberg, data as of 29/4/2022

UK 10-year Government Bond Yield



Source: Bloomberg, data as of 29/4/2022

British Pound Exchange Rate



Source: Bloomberg, data as of 29/4/2022

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