Economic Research

December 2022

*Market Monitor – United Kingdom*

# Fiscal U-turn and Fresh Inflation Record


## GDP fell by 0.2% QoQ in Q3, dragged down by the Queen's state funeral

The UK economy recorded a 0.2% quarter-to-quarter (QoQ) decline in Q3 2022, reversing a positive 0.2% QoQ growth in Q2, being the first QoQ contraction since Q1 2021. The smaller-than-expected contraction in Q3 was driven by the significant upwards revision in July and August. The 0.6% month-on-month (MoM) contraction in September was the result of an extra Bank holiday for the Queen's state funeral and the weak underlying trend. Household consumption and business investment both fell 0.5% QoQ, reflecting the impact of rising inflation, geopolitical uncertainty, and aggressive rate hikes by the Bank of England (BoE) on UK households and businesses. Meanwhile, positive contributions from net trade and public consumption slightly offset the contractions.

Amid a gloomier economic condition, October inflation recorded another upside surprise, with headline consumer price index (CPI) jumping from 10.1% year-on-year (YoY) in September to a 41-year high of 11.1% in October. The core CPI recorded YoY growth of 6.5%, remaining unchanged from the previous month. The Office for National Statistics (ONS) revealed that households were paying, on average, 88.9% more for their electricity, gas, and other fuels than they were a year ago, while food prices saw a 16.4% YoY growth in October, the highest since September 1977. Even though the Energy Price Guarantee (EPG) will be raised in April 2023 and the upside surprise raises questions about how fast inflation will return to the policy target, both headline and core inflation have likely peaked.

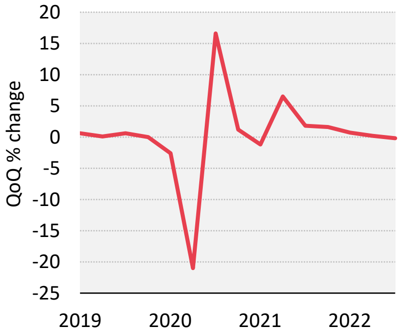
Amid the softening growth momentum, the tight employment market might show an initial sign of moderation, with strong pay lags slowing job growth. The unemployment rate edged 0.1 percentage point higher from the 3.5% in June to August 2022 to 3.6% in Q3 2022. Though the rise in unemployment rate was modest in Q3 2022, the strong readings for July and August implied that the September unemployment rate has increased to 3.8%. Nevertheless, average weekly earnings including bonuses rose 6.0% (YoY) in Q3 2022, down from a 6.1% growth in June to August, however, regular pay growth edged 0.2 percentage points higher to 5.7% during the same period. As such, the

**UK GDP recorded a 0.2% QoQ drop in Q3, mainly due to the contraction in private consumption and investment.**

**Headline CPI saw an 11.1% YoY increase amid surging food and energy prices, hitting a 41-year high.**

**Multiple headwinds will continue to hit the UK economy ahead.**

**UK GDP**




Source: Bloomberg

employment market data has something for both hawks and doves, with the former pointing to the rise in wage growth as inflation, and the latter referring to red flags in unemployment.

## Fiscal U-turn and further rate hikes expected

In the UK Autumn Statement, the UK changed its fiscal plan from one of the most expansionary in recent history to one that is focused on fiscal discipline. On 17th November 2022, Rishi Sunak's administration proposed GBP 54 billion worth of tax rises and spending cuts, but with economic and political considerations aligning to produce a heavily back-loaded tightening after a probable 2024 election. Tax measures included a broadening of the windfall tax on energy profits and the freezing of various tax thresholds on income, capital gains and employer national insurance contributions. The Income Tax additional rate threshold (ART) will also be lowered to GBP 125,140 from GBP 150,000. The EPG will rise to GBP 3,000 per year starting from April 2023, 20% higher than the current EPG. Against this backdrop, the Office for Budget Responsibility (OBR) forecasts the UK economy to contract by 1.4% in 2023, with the unemployment rate increasing to 4.6% and 4.9% in Q4 2023 and Q2 2024 respectively.

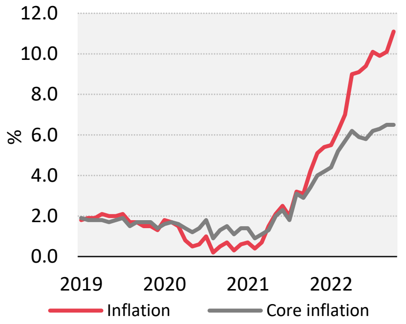
Some might argue that in the future, fiscal tightening could justify less monetary tightening by the Bank of England (BoE). However, most of the fiscal squeeze will occur after the 2024 election and that will be too late to help the BoE control inflation over its two-year horizon. The Autumn Statement also includes a more generous Energy Bill Support Scheme which may raise the BoE's 2023 growth forecast. Combined with the wage and CPI surprises, the BoE is expected to further increase its Bank Rate in December and Q1 2023.

Against this backdrop, the UK property market saw signs of cooling. The Nationwide Housing Price Index has declined for three straight months, with the MoM drop widening to 1.4% in November from 0.9% in October. With the expectation that the BoE will further raise the interest rate, the risk of further decline in property prices will intensify in the coming months.

## Recession largely expected in 2023

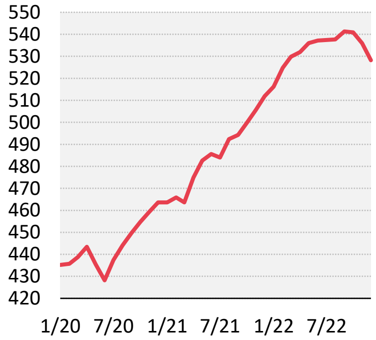
Looking ahead, the UK economy will continue to be clouded by multiple headwinds including geopolitical uncertainty, supply-side concern, elevated inflation, rapidly tightening monetary environment, and proposed fiscal tightening, etc., with recession already expected by BoE, OBR and most market participants. However, the UK flash composite PMI edged 0.1 percentage point higher to 48.3 in November, the fourth consecutive month below the boom-bust line of 50. Despite the weak PMI, price and supply chain related indicators continue to show improvement. If the composite PMI doesn't decline notably further, this could imply that the recession might not be as severe as originally expected. Similarly, consumer confidence remained weak in November, with the Gfk consumer confidence index staying deeply negative at -44, but up from the -47 in October.

**UK Inflation**



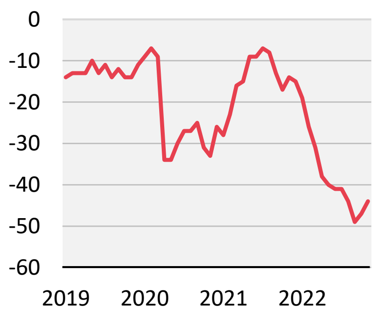

Source: Bloomberg

**Nationwide Housing Price Index**




Source: Nationwide Building Society

**UK Gfk Consumer Confidence Index**



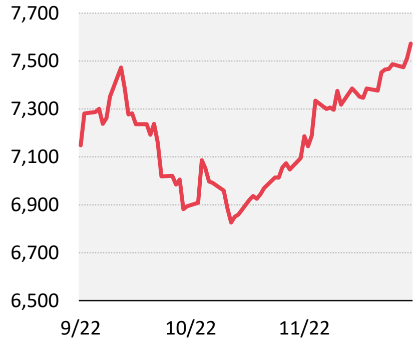

Source: Bloomberg

## Global financial market sentiment improves with the expectation that the worst inflationary pressure might pass

As US saw slower inflation in October, market participants increasingly expect a smaller rate hike by the Federal Reserve (Fed) at upcoming meeting. Major equity markets continued to record gains in November. As of the 30th November, the FTSE 100 Index was about 6.7% higher than at the end of October. Meanwhile, the US dollar has weakened against major currencies, including the British pound. As of the 30th of November, the British pound appreciated 5.1% against the US dollar but depreciated 0.1% against the euro.

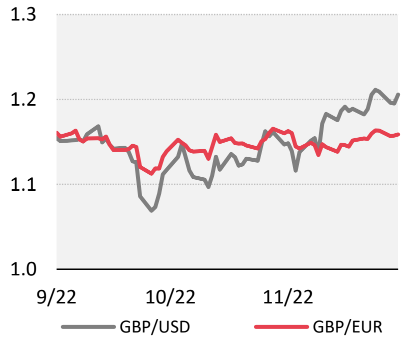
In the bond market, UK government bond yields edged lower in November after fiscal U-turns by the Sunak administration. As of the 30th of November, the 10-year UK government bond yield stood at 3.161%, down 36 basis points from the end of October.

**FTSE 100 Index**



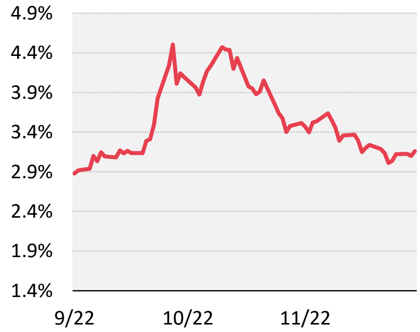

Source: Bloomberg, data as of 30/11/2022

**British Pound Exchange Rate**




Source: Bloomberg, data as of 30/11/2022

**UK 10-year Government Bond Yield**




Source: Bloomberg, data as of 30/11/2022

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