

2024 outlook - UK macro and bonds

Stagflationary pressures to linger

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FLASH NOTE

SUMMARY

- We forecast 0% GDP growth in the UK in 2024 (after +0.4% in 2023), below consensus, including a small technical recession around summer. We expect the main drag on activity to come from this year's sharp tightening of financial and credit conditions which should keep feeding through to the real economy, including housing, corporate margins and the labour market. Mitigating factors would include an improvement in real disposable income as nominal wage growth remains elevated and inflation eases from very high levels.
- Fiscal policy will be the UK economy's wild card in 2024. The government may use the extra fiscal space to launch fresh stimulus measures ahead of the forthcoming election, although their impact looks uncertain. Should the UK enter a more severe slowdown, this fiscal room would quickly evaporate. Whoever wins the election will remain under pressure to tighten fiscal policy.
- We expect UK inflation to slow from an average of 7.3% in 2023 to 2.6% in 2024, also below consensus. Headline inflation should ease faster than core, helped by lower energy, food and utility prices, while services inflation is likely to remain sticky. Ultimately, a weakening labour market should help wage growth and core inflation ease further into the second half of next year.
- The Bank of England (BoE) will keep resisting rate cuts, focusing instead on the transmission of monetary policy. We forecast a first 25bp rate cut in June and a total of 100bp of easing in 2024, bringing the Bank rate down to 4.25% by year-end.
- Maintaining fiscal credibility is crucial for the UK government to prevent a recurrence of the mini-budget crisis and to attract investors. We expect the 10-year gilt yield to end 2024 around 4%, slightly lower than its US counterpart due to the lower economic growth we project in the UK. Structurally higher inflation leads us to maintain a neutral stance on UK government bonds.

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TEXTBOOK CASE FOR STAGLFATION?

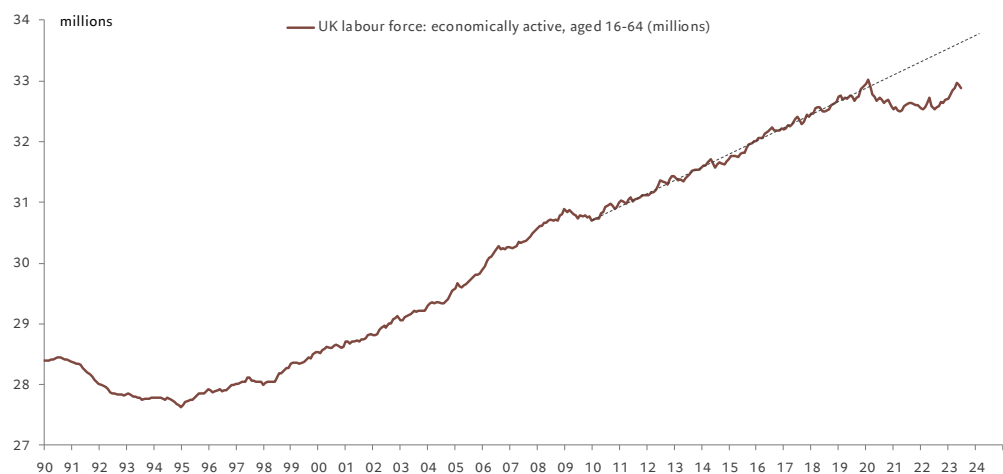
Few countries illustrate the tension between supply and demand factors better than the UK. Faced with the historic shocks of Brexit, the pandemic, and the war in Ukraine, the UK economy suffered very significant damage to its supply-side followed by the largest increase in inflation in the developed world which, in turn, has forced the BoE to hike interest rates by more than 500bp since the end of 2021. Politics haven't helped either, with former PM Liz Truss' 'mini-budget' crisis inflicting more pain on the UK fixed income markets and pension system.

Despite all this, the UK economy has fared better than expected this year, avoiding recession against the backdrop of the fastest tightening in financial conditions in post-War history. We continue to expect further weakness in activity although our forecast resembles a slow burn more than an abrupt collapse. Indeed, the economy is likely to benefit from some tailwinds including a rise in real wages as inflation eases, as well as a modest boost from the government's recent fiscal support measures. That said, the underlying economic momentum remains weak, tighter financial and banking conditions continue to feed through to the real economy, and the latest data has been consistent with early cracks in the labour market.

We expect UK inflation to slow from an average of 7.3% in 2023 to 2.6% in 2024, also below consensus. Headline inflation should ease faster than core, helped by lower energy, food and utility prices. Services inflation is likely to remain stickier for longer, but it has started to ease and a weakening labour market should help wage growth and core inflation decline further into the second half of next year.

We don't necessarily subscribe to the Phillips curve analysis at all times, but if there's one country where a recession might be "needed" for inflation to come under control, it would be the UK. **The first disinflation phase from 11% to below 5% has been relatively swift and painless, but the last mile from 5% to 2% is likely to be more difficult.** Given the structural damage to labour supply in particular, demand needs to be dampened to a lower level than in other countries, all else being equal, for wage growth and domestic inflation to slow.

Chart 1: the damage done (to the supply-side of the UK economy)



Source: Office for National Statistics, Pictet Wealth Management, as of 18.12.2023

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THE FISCAL WILD CARD

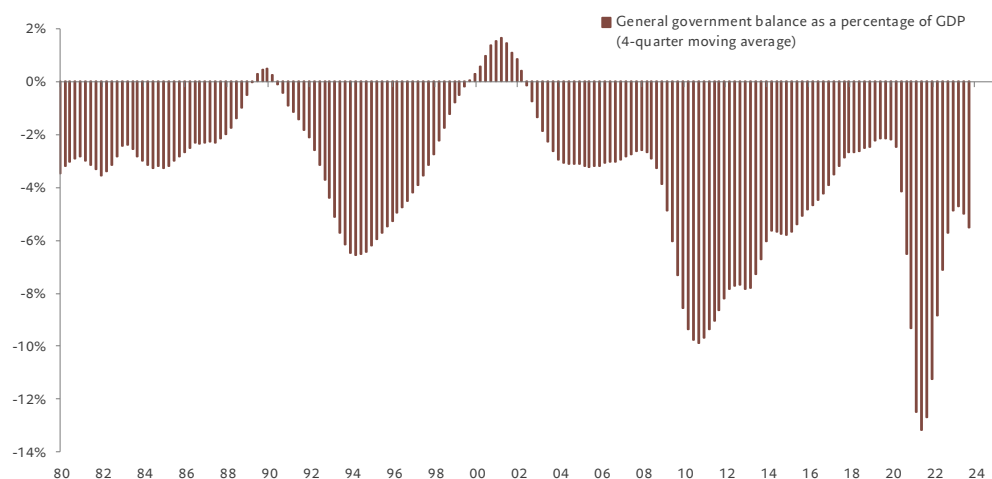
The main uncertainty – and potential upside risk to growth in 2024 – comes from fiscal policy ahead of a likely election in the second half of the year. Opinion polls point to a victory for the opposition Labour Party at the next general election, which must be held no later than 28 January, 2025 but is more likely to take place in 2024. Under the leadership of Keir Starmer, Labour has stressed its emphasis on economic stability and fiscal responsibility. The party’s shadow finance minister, ex-Bank of England economist Rachel Reeves, wrote in the Financial Times in September: “I will never spend what we cannot afford ... we will reduce national debt as a share of the economy ... We will ensure stability returns to our economy.”

Indeed, the backdrop for any government, this one included, will remain haunted by Liz Truss’ mini-budget and Liability Driven Investment (LDI) funds crisis that ultimately forced a change in fiscal course. From now on, any Conservative or Labour government is likely to err on the side of fiscal prudence in order to avoid a return of financial instability.

That said, the unexpected resilience of the economy in recent years as well as the sustained rise in inflation-generated, larger-than-expected fiscal revenues in 2023, generated some additional fiscal space to the tune of GBP30bn. The current government used some of this space **in its Autumn budget statement, announcing a set of new fiscal measures**, including a 2pp decline in payroll taxes (national insurance contributions), a permanent tax credit scheme for companies (full expensing capital allowance which was previously scheduled to end in 2026), as well as structural reforms aimed at increasing the participation rate.

These support measures may still look reasonably calibrated, but the government could be tempted to do more next year, via new spending or tax cuts, to boost its electoral base ahead of the election. While that may provide the economy with a short-term tailwind, any new stimulus programme may also fuel concerns of a possible reacceleration in inflation down the road.

Chart 2: General UK government balance as a percentage of GDP



Source: Office for National Statistics, Pictet Wealth Management, as of 18.12.2023

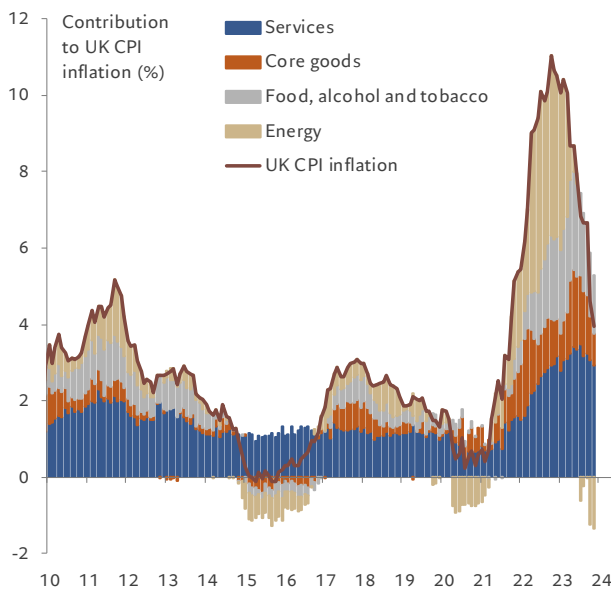
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BOE TO RESIST EASING PRESSURES UNTIL THEY DON'T

The BoE has been resisting rate cuts so far, focusing instead on the transmission of tight monetary policy. Barring a more severe economic slowdown and a rise in unemployment, the BoE is unlikely to pivot over the next few months even if the Fed and the ECB do.

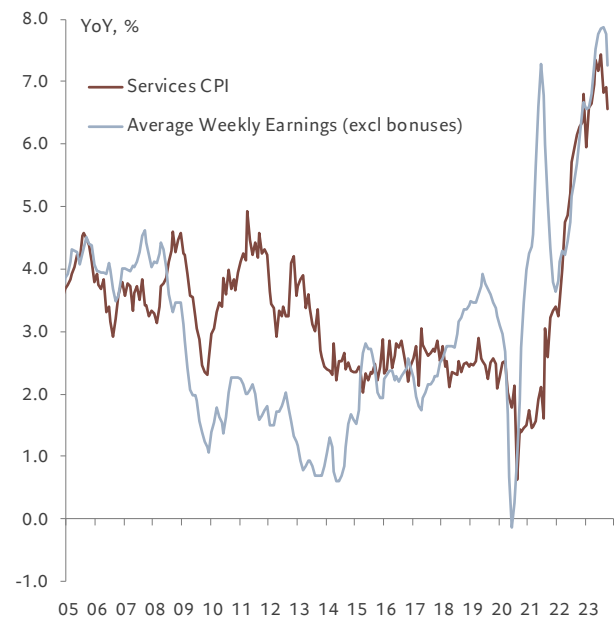
We forecast a first 25bp rate cut in June and a total of 100bp of easing in 2024, bringing the Bank rate down to 4.25% by year-end. Risks are tilted towards the BoE cutting rates later in H2, but either way we expect the easing cycle to extend into 2025. We also forecast Quantitative Tightening (QT) to continue at the same pace while the BoE cuts rates, although the Monetary Policy Committee to shift to a more gradual approach in the event of a more protracted slowdown in growth and inflation.

Chart 3: contributions to CPI inflation



Source: Office for National Statistics, Pictet Wealth Management, as of 20.12.2023

Chart 4: services CPI and wage growth



Source: Office for National Statistics, Pictet Wealth Management, as of 20.12.2023

BALANCING FISCAL CONFIDENCE AND INVESTOR APPETITE

This year, the 10-year UK gilt delivered a flat performance, recovering from the difficulties encountered during the mini-budget crisis in 2022, which had caused a substantial 20% decline in performance. The 10-year yield was volatile and returned to a similar level at which it began the year. Nevertheless, investors still remember the gilt market debacle that occurred after the announcement of PM Liz Truss' mini-budget. This event left a lasting impression, as it necessitated the BoE to resume bond purchases while on the verge of ending its pandemic emergency purchases of government bonds.

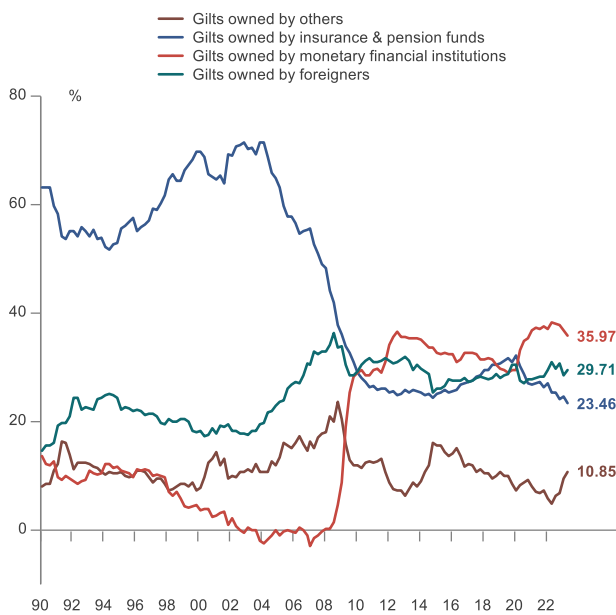
In the medium-term, ensuring the UK's government fiscal credibility is crucial to preventing a recurrence of this kind of incident. This becomes even more

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central considering the appealing alternatives available in the global fixed-income market. It is worth noting that insurance and pension funds have decreased their gilts holdings after last year’s UK bond market scare. However, other holders such as financial institutions and private non-financial corporations appear to be more inclined to increase holdings in UK government bonds. This is evident from the increase in ‘others’ holdings from 5.0% in June 2022 to 10.9% in June 2023 given appealing yields (see chart 5).

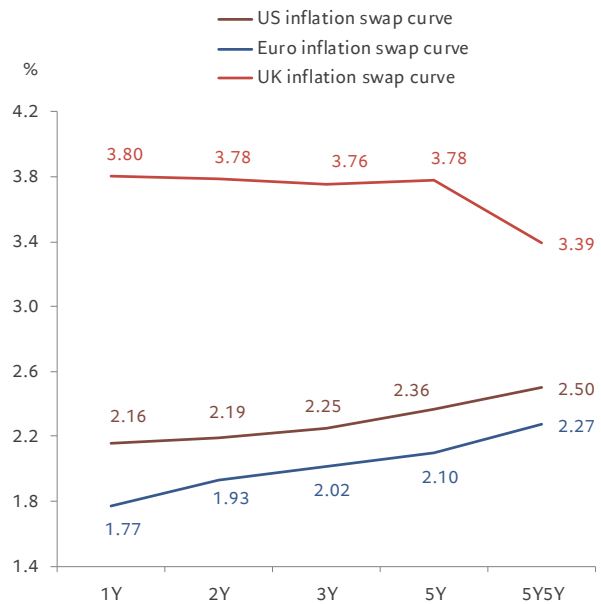
Foreign investors currently hold the largest share of UK gilts after the BoE with approximately 30%, making it imperative to maintain their confidence and trust in the market. This level has remained relatively stable in recent years, indicating that foreign investors may continue to maintain their current level of holdings if fiscal stability is demonstrated. But foreign capital is typically more unpredictable due to the lack of information regarding the identity of overseas holders of gilts. In this context, it will be necessary for domestic demand to step forward and play a central role in bond holdings. This is especially the case with the BoE gradually decreasing its presence in the gilt bond market through QT, after being a consistent buyer for over ten years.

Chart 5: share of gilts held in % of total outstanding



Source: Pictet Wealth Management, FactSet, as of Q2 2023

Chart 6: US, UK and euro inflation swaps curves



Source: Pictet Wealth Management, Bloomberg Finance L.P., as of 20.12.2023

Discussing the capacity of different investors to absorb UK government bond issuances is crucial as these are projected to continue increasing over the next two fiscal years, as indicated by the Office for Budget Responsibility (OBR, <https://obr.uk/>). They forecast a rise in net issuance (nominal amount of debt issued by the government net of redeeming debt) from 4.4% to 4.6% of GDP in 2024-2025. Given that QT contributes to the expansion of the debt in circulation, the projected increase in private sector holdings is expected to reach its highest level on record at 7.9% of GDP in 2024-2025. In conclusion, high gilt issuance and the unwinding of the Asset Purchase Facility (APF) gilt holdings by the BoE mean that the private

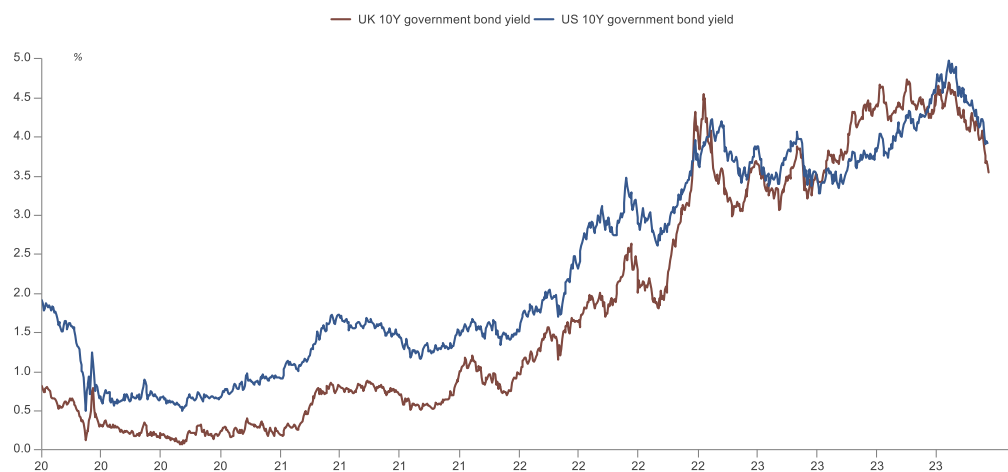
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sector will have to absorb the elevated supply over the coming years. As such, maintain a sustainable trajectory for UK public debt is crucial for UK government bonds investors.

The future trajectory of policy rates also holds substantial importance, particularly as the Federal Reserve has announced its intention to embark on a rate cutting cycle in 2024. Currently, we believe it is only a matter of time before the BoE starts thinking about monetary policy easing as well. Nevertheless, the BoE will take into consideration the UK's structurally higher inflation compared to other developed countries, due to its services-oriented economy and its tight labour market resulting from Brexit. This is reflected in the market where investors are expecting UK inflation to stay 3.8% over a one-year horizon but to fall to 2.2% in the US (on 20 December, see chart 6). Consequently, the Fed is perceived as being more credible in achieving its 2% inflation target than the BoE.

Structurally higher inflation in the UK means we see, UK gilts as less attractive than their US counterpart, which explains our **neutral stance on UK government bonds** while favouring an overweight position on US Treasuries. **We expect the 10-year gilt yield to end 2024 around 4%, which is lower than our 4.3% forecast on the 10-year US Treasury yield and is mostly due to the lower growth we project in the UK.** Also in the near term, we perceive a lower level of risk associated with short-term fiscal slippage in the UK compared to the US, despite both countries facing a potential change in government next year. While the US is still engaged in discussions over the 2024 budget, the United Kingdom has released its Autumn budget statement which gives some visibility over government finances in 2024.

Chart 7: 10-year UK and US government bond yields



Source: Pictet Wealth Management, FactSet, as of 19.12.2023

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