UK macro update

Paving the way for BoE easing

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FLASH NOTE

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SUMMARY

- We maintain our forecast of moderate economic growth in the UK, including a slightly stronger recovery in the second half of this year with upside risks. Annual GDP growth would still average 0% in 2024 due to the strongly negative carryover effect from the contraction recorded in H2 2023.
- Tailwinds propelling the economy forward include the diminishing impact of energy shocks, which is boosting real income, the fading transmission of monetary policy tightening on credit growth, and an improvement of business activity indices. However, adverse shocks on the supply side continue to act as a major structural drag on the economy.
- Core inflation remains well above the Bank of England's 2% target, but we believe that the disinflationary process is still underway as wage growth has peaked. The latest easing in inflationary pressure can be attributed to lower core goods, energy and food prices, while services inflation has only recently begun to show signs of slowing. We continue to forecast an average inflation of 2.6% in 2024, down from 7.3% in 2023, with core inflation anticipated to ease more slowly than headline due to persistent services inflation.
- The latest Monetary Policy Committee (MPC) decision in March 2024 provided early signs of a dovish pivot, but the timing of rate cuts remains uncertain as the Bank of England (BoE) wants to "remain restrictive for sufficiently long". We continue to expect the BoE to cut rates in June and to ease by 100bp in total this year, lowering the Bank rate to 4.25% by end-December.
- The 2024 Spring budget delivered a new set of fiscal measures, including a 2 percentage point (pp) cut in National Insurance contributions, to support short-term economic growth. Nevertheless, we do not expect these measures to materially influence the timing of BoE rate cuts. The Spring budget unfolds against the backdrop of a particularly high debt-to-GDP ratio, leaving limited room for any additional fiscal easing in the future.

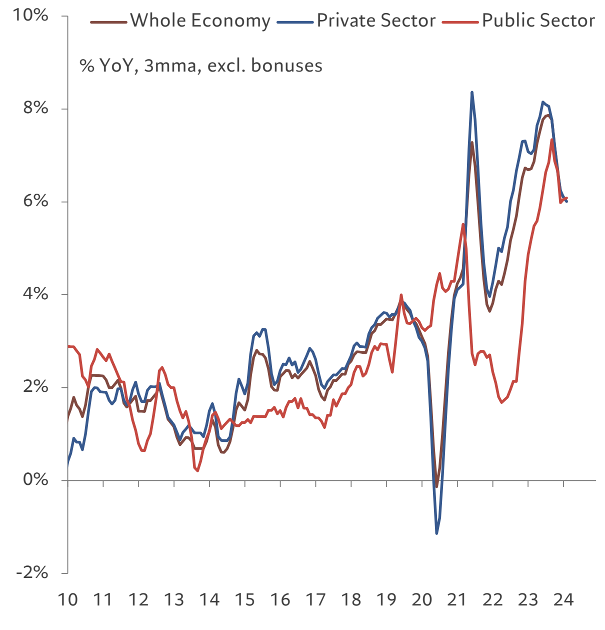
WAGES AND PRICES PAVING THE WAY FOR BOE EASING

After years of weak growth momentum, we believe that the UK economy is finally poised for a gradual recovery in the short-term, and potentially for stronger growth in the medium term.

Crucially, **while the supply-side of the economy remains depressed and the labour market tight, recent data have been consistent with a deceleration in wage growth**. This slowdown has eased inflationary pressures that have been building up in the economy. These economic trends are unfolding against a backdrop of a significant decline in labour disputes in the first half of 2023.

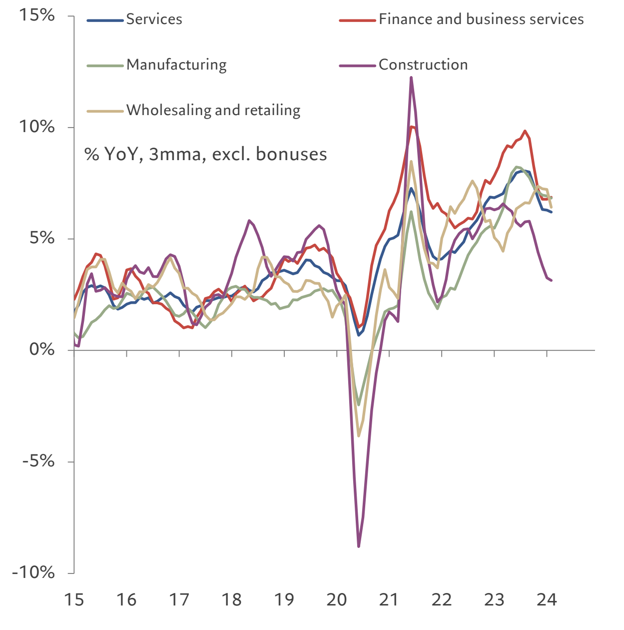
Since 2019, wage growth in the public and private sectors has diverged. This disparity can be attributed to the government's decision to offer, on average, wage increases below the inflation rate for the public sector. Indeed, the 2020 Spending Review implemented a one-year pay freeze for all workers in 2021, with the exception of those working in the National Health Service (NHS) and low-income employees. This decision led to strikes, thereby reducing the number of working days. Following a strong rise since 2022, we believe public wage growth has now normalised, aligning with the private sector, and is likely to continue declining in the coming months.

Chart 1: Nominal wages (excl. bonuses)



Source: Pictet Wealth Management, Office for National Statistics, as of 23.04.2024

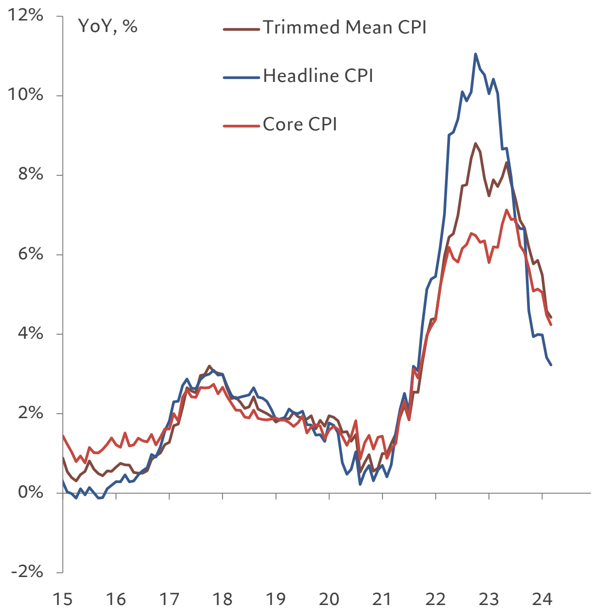
Chart 2: Nominal wages (excl. bonuses) per activity



Source: Pictet Wealth Management, Office for National Statistics, as of 23.04.2024

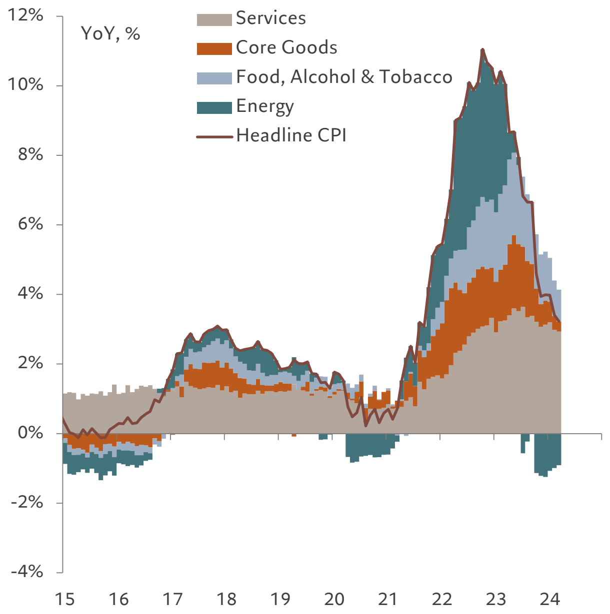
In recent months, UK headline inflation has been declining swiftly, falling to 3.2% year-over-year in March, down from a peak of 11% in October 2022. This decline can be attributed to falling prices in core goods, food and energy. Core inflation has also declined, albeit to a lesser extent as the cost of services has remained relatively sticky. Assuming wage growth has peaked indeed, **we forecast an average headline inflation of 2.6% in 2024, down from 7.3% in 2023**.

Chart 3: Headline, core & trimmed mean CPI



Source: Pictet Wealth Management, Office for National Statistics, as of 23.04.2024

Chart 4: Headline CPI inflation contributions



Source: Pictet Wealth Management, Office for National Statistics, as of 23.04.2024

LITTLE ROOM LEFT FOR ADDITIONAL FISCAL EASING

The 2024 UK Spring budget included several key measures that aimed at lowering taxes while delivering additional investments and fostering positive long-term growth. Chancellor of the Exchequer Jeremy Hunt announced several significant changes, including a 2 percentage point (pp) reduction in employee National Insurance (NI) contributions (which comes on top of the 2pp cut contained in the 2023 Autumn Statement), and a 4pp cut in the higher rate of capital gains tax on property, bringing it down from 28% to 24%. The salary threshold for paying the high income tax charge on child benefits was also increased.

In order to raise additional revenue, the government extended windfall taxes on oil and gas companies until 2029, decided to scrap the non-domicile tax regime from April 2025 and implemented other tax increases, such as on tobacco and non-economy air travel tickets.

Despite the announced NI tax cuts, personal taxes are still expected to increase due to the multi-year tax threshold freeze from 2021, instead of being indexed to inflation. Additionally, the Spring budget comes against the backdrop of a significantly high debt-to-GDP, leaving an estimated headroom of only GBP8.9 bn for 2028-2029 compared with GBP3 bn in the 2023 Autumn Statement. **These measures are expected to support the economic recovery in the short term, but we do not anticipate them to significantly influence the timing of BoE rate cuts**.

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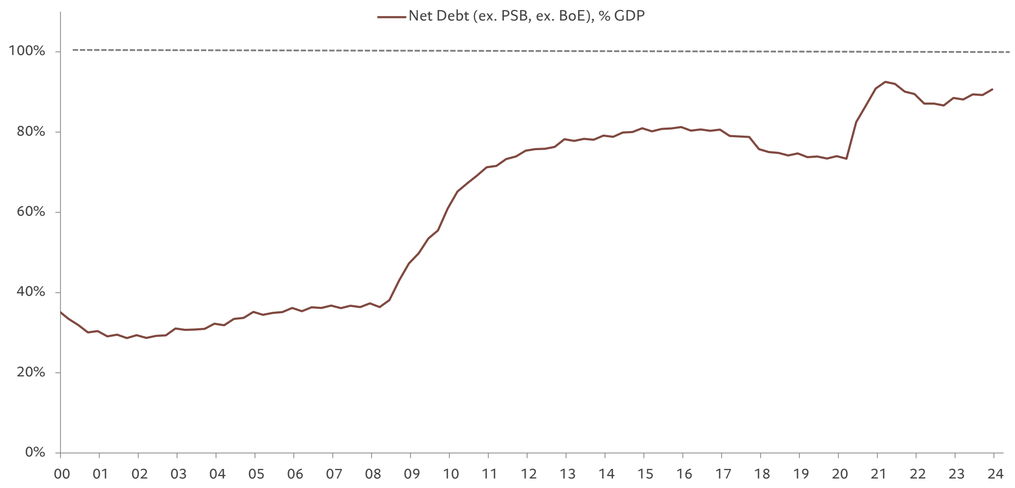
Chart 4: Net debt (excl. public sector-controlled banks and BoE) per GDP



Source: Pictet Wealth Management, Office for National Statistics, as of 23.04.2024

In addition, we believe the UK economy has progressively recovered from the adverse impact of Liz Truss's short-lived 'mini-budget' of late 2022, thereby reducing its exposure to such economic burden. In addition, we believe that a probable Labour Party victory in the upcoming general election (due to be held no later than in January 2025) will not disrupt the economy while potentially resulting in improved relations with the EU.

HOW LONG CAN THE BOE RESIST?

As expected, the Bank of England's Monetary Policy Committee (MPC) kept interest rates unchanged at 5.25%, at its last meeting in March. However, there were increasing signs of a dovish shift, with two previously hawkish members dropping their call for a rate increase. The meeting statement reiterated that monetary policy needs to remain restrictive while the MPC said it was "keeping under review" how long rates should remain on hold.

The MPC's decision and guidance were supported by encouraging news on inflation, which declined more than projected for February. Inflation is expected to sink further, reaching temporarily the Bank's 2% target in Q2 before rising due to the fading negative growth of energy prices. Tightness in the UK labour market continues to ease as inflation expectations are receding, contributing to a fall in most pay growth indicators. The MPC forecasts an improvement in growth in H1 following the contraction in H2 2023, with the Spring Budget measures described as a net positive. However, these measures are estimated to boost GDP by only around 0.25% over the coming years.

Our central forecast remains that the BoE will start to cut rates in June, with total easing of 100bp this year bringing the Bank rate down to 4.25%. However, depending on upcoming inflation and wage data, there is a possibility that the BoE may wait until August, as the March CPI has surprised to the upside due to stickier-than-expected services. Once the rate cuts begin, the BoE will have some room to manoeuvre given a relatively high starting point, with the easing cycle likely to

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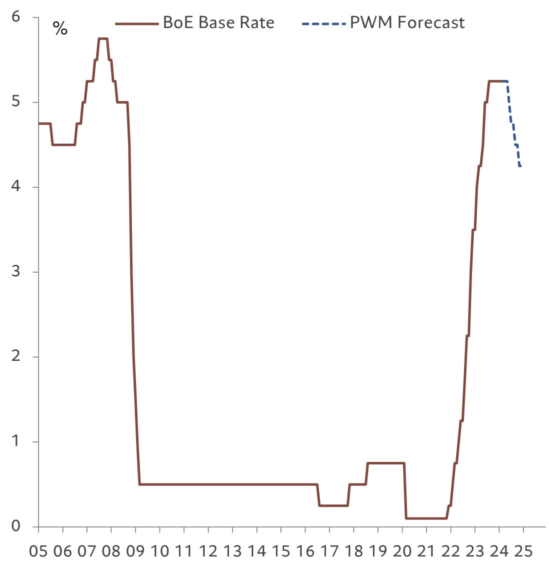
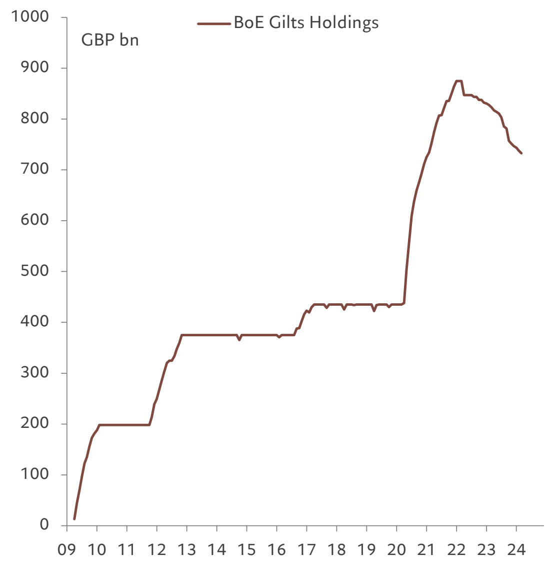
extend into 2025. Nonetheless, in light of persistent inflation in the US (as borne out by the CPI for March), there is a risk that the BoE's initial leeway is limited by a more hawkish Federal Reserve.

Chart 5: BoE base rate & PWM forecast



Source: Pictet Wealth Management, Bank of England, as of 23.04.2024

Chart 6: BoE gilts holdings



Source: Pictet Wealth Management, Bank of England, as of 23.04.2024

Overall, our forecast of an ongoing bumpy disinflation process, coupled with the diminishing drag from monetary policy transmission and an improvement in business activity, are all consistent with a gradual economic recovery in the UK. We maintain our forecast of 0% GDP growth in 2024, although **we see the balance of risks as skewed to the upside for the first time in several years**. We expect a moderate growth in H1 followed by a marginal acceleration in H2 which could extend into 2025 potentially at a stronger pace.

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