Economic Perspectives

UK and international economic and financial outlook

prepared for SMPC meeting

Peter Warburton

10 January 2023

International outlook

- Entering 2023 with a very different outlook to 2022. Economic activity decelerating into declines for most advanced economies this year
- Hopes of a powerful re-opening dynamic in China are key reason why global growth forecast stays positive
- Inverted yield curves – except in Japan – reflect a year of concerted increases in short-term rates
- Inflation momentum is softening, but not as quickly or as significantly as central banks require
- Huge global imbalances between net exporters and net importers of natural resources is a potential source of financial instability

Mainstream forecasts hold on to a little growth in 2023

- … and inflation easing back

December Survey	Real GDP % increase			Consumer Prices % increase			Current Account Balance, US$bn		
	2021	2022	2023	2021	2022	2023	2021	2022	2023
Belgium	6.2	2.6 ↑	0.2 ↓	2.4	10.1 ↑	6.5 ↑	-2.4	-17.0	-10.3
Canada	5.0	3.4 ↑	0.4 ↓	3.4	6.8 ↓	3.8	-5.4	5.1	2.2
France	6.8	2.5	0.1 ↓	1.6	5.5	4.7 ↑	10.2	-47.9	-51.8
Germany	2.6	1.7 ↑	-0.7 ↑	3.1	8.3 ↑	7.0 ↑	313.4	149.4	161.1
Italy	6.7	3.7 ↑	-0.1 ↑	1.9	8.3 ↑	6.3 ↑	64.4	-19.9	-17.3
Japan	1.7	1.5	1.3 ↓	-0.2	2.4 ↑	1.8 ↑	196.1	71.4	78.5
Netherlands	4.9	4.4 ↓	0.2	2.7	11.1 ↑	7.0 ↑	72.8	62.8	67.1
Norway	4.1	3.1 ↑	0.8 ↓	3.5	5.7	4.4 ↑	72.1	105.9	99.3
Spain	5.5	4.5	0.8	3.1	8.6 ↓	4.5 ↑	13.6	4.5	3.3
Sweden	5.1	2.9 ↑	-0.4	2.2	8.0 ↓	6.4	34.0	18.7	19.9
Switzerland	4.2	2.1	0.5	0.6	2.9	2.3 ↑	59.2	59.2	57.3
United Kingdom	7.5	4.4 ↑	-1.0 ↓	2.6	9.0 ↑	7.3 ↑	-62.8	-164.1	-126.3
United States	5.9	1.9 ↑	0.2	4.7	8.1	4.1	-846.4	-972.7	-921.0
North America[1]	5.9	2.0	0.3	4.6	8.0	4.1	-851.7	-967.6	-918.8
Western Europe[2]	5.5	3.3	-0.1	2.4	7.9	5.9	670.0	240.6	319.8
European Union[2]	5.3	3.2	0.1	2.6	8.7	6.4	567.0	149.6	218.4
Euro zone[2]	5.3	3.2	-0.1	2.6	8.5	6.3 ↑	341.5	-85.6	13.8
Asia Pacific[3]	6.1	3.3	3.5	1.5	3.4	2.9	796.9	564.7	492.4
Eastern Europe[4,7]	6.3	0.1	0.2	8.7	23.1	14.0	58.5	93.2	49.2
LatAm ex Venezuela[5,7]	6.9	3.2	1.1	11.8	16.1	12.8	-73.3	-120.8	-108.9
Other Countries[6]	4.5	5.4	2.9	6.3	8.4	8.0	60.3	160.4	112.0
Total[7]	5.9	2.8	1.5	3.6	7.5	5.1			

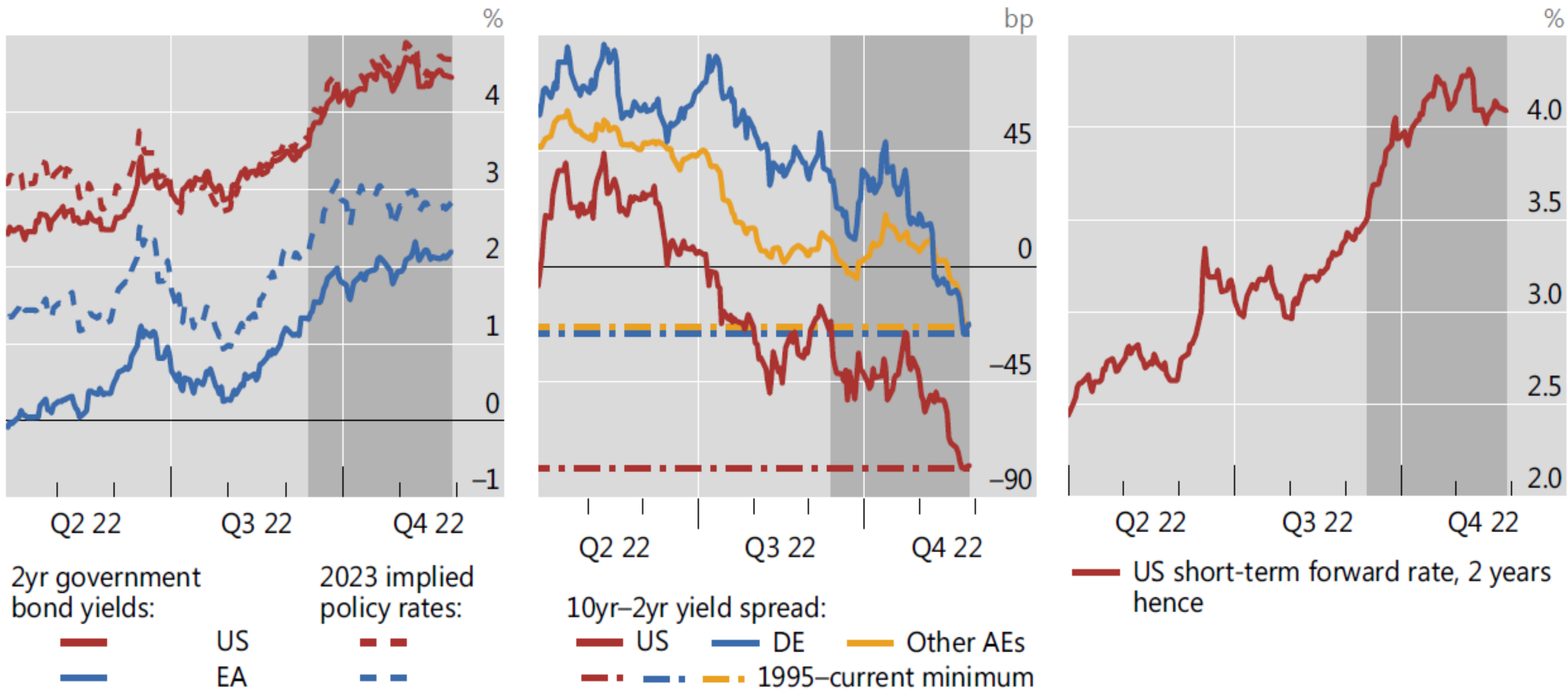
A cost of credit crisis is on the way

Short-term yields climbed in anticipation of tighter monetary policy[1] Graph 1

A. Market-implied policy rates rose

B. Yield curves inverted to historical lows

C. Perceived terminal rate pulled back after an extended increase



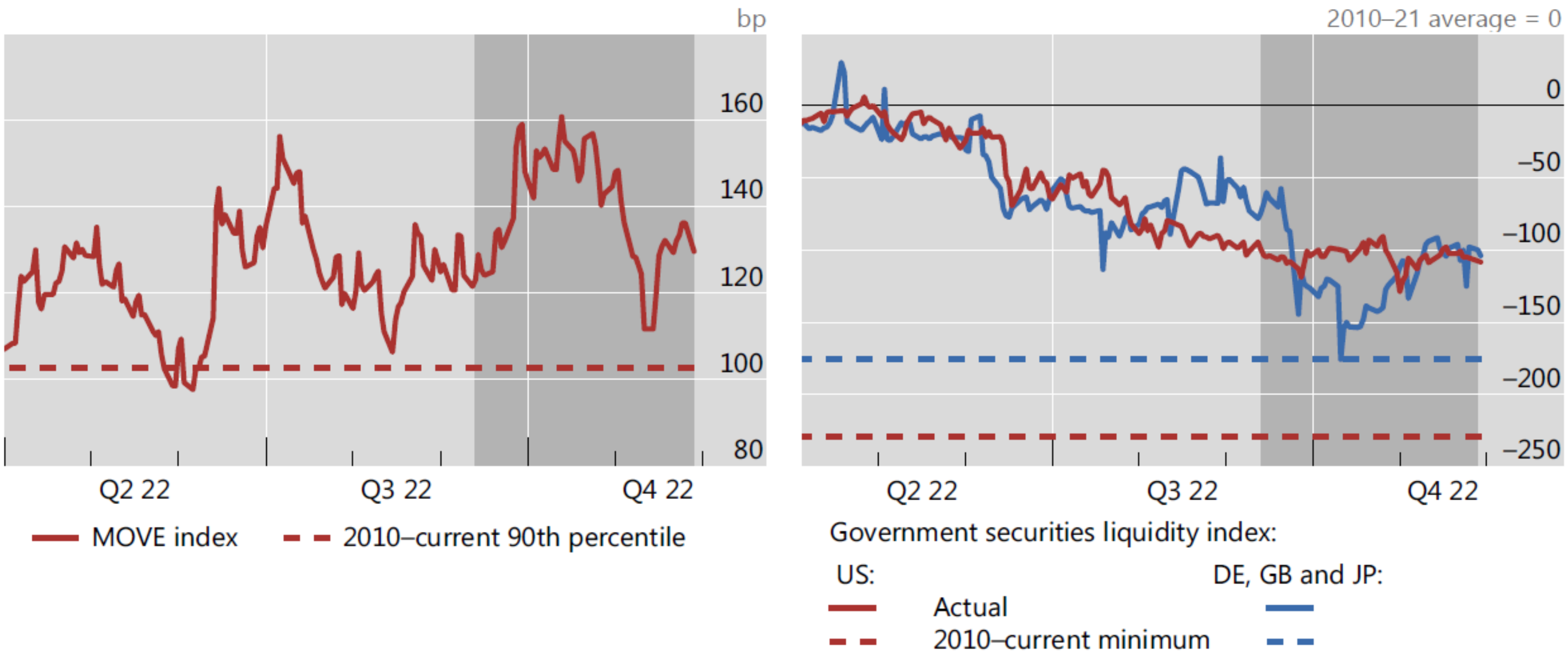
The shaded areas indicate 13 September–25 November 2022 (period under review).

Bond volatility, elevated; market liquidity, plunging

As rates uncertainty remained high, liquidity conditions deteriorated[1] Graph 2

A. Implied volatility for Treasury yields was elevated

B. In many core bond markets, liquidity worsened



The shaded areas indicate 13 September–25 November 2022 (period under review).

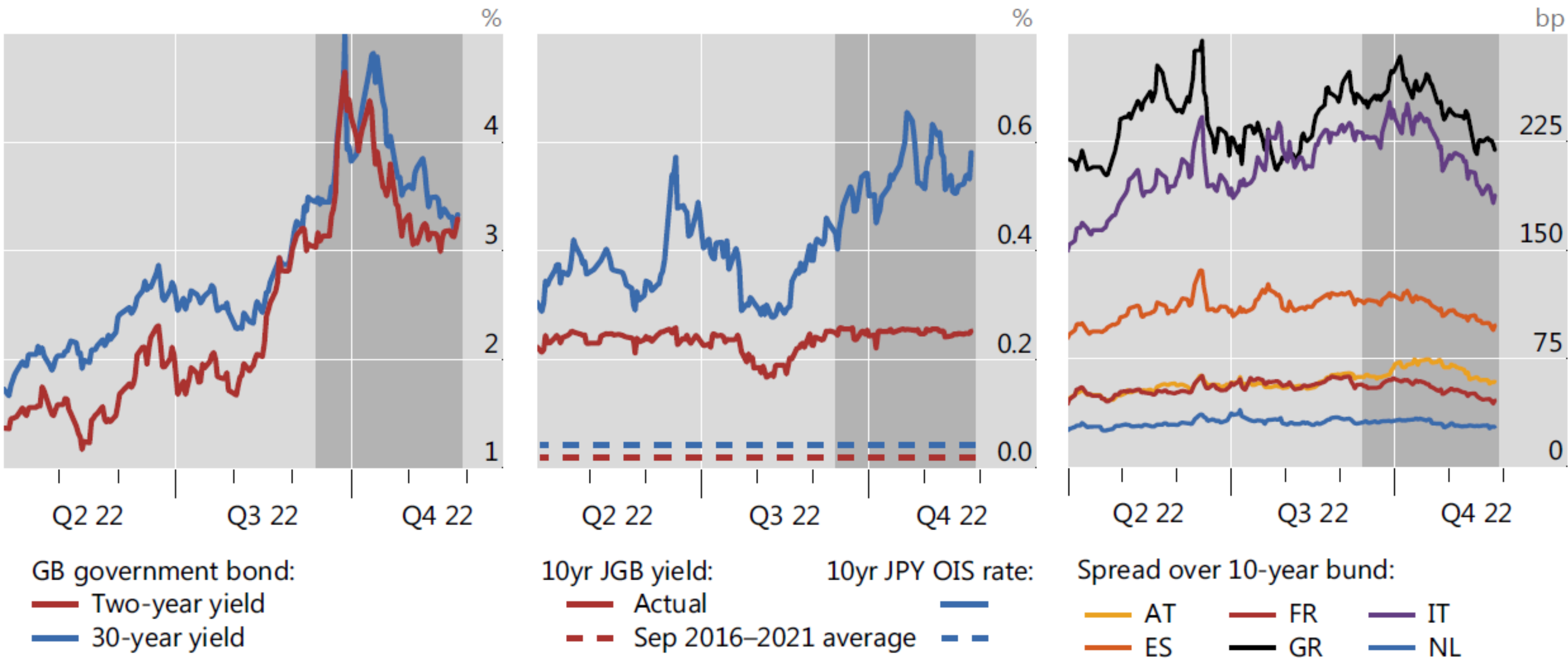
Yet sovereign bond markets (ex-UK) are serene

Euro area sovereign spreads compressed amid dislocations in other AEs Graph 3

A. UK yields spiked during the gilt turmoil in late September

B. Investors showed doubts about Japan's yield curve control

C. Euro area sovereign spreads stayed elevated in some countries

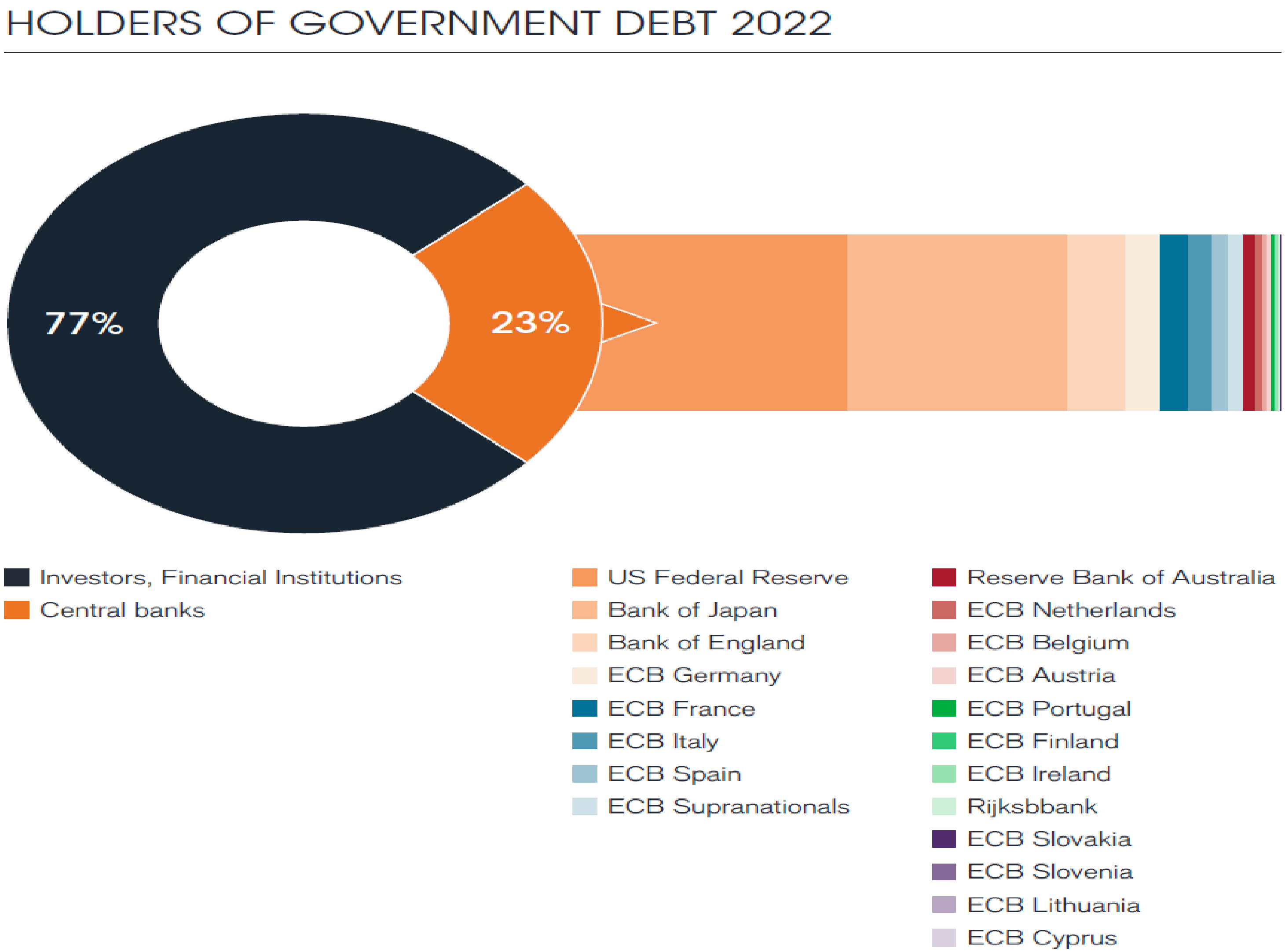


The shaded areas indicate 13 September–25 November 2022 (period under review).

Sources: Bloomberg; BIS.

Economic Perspectives

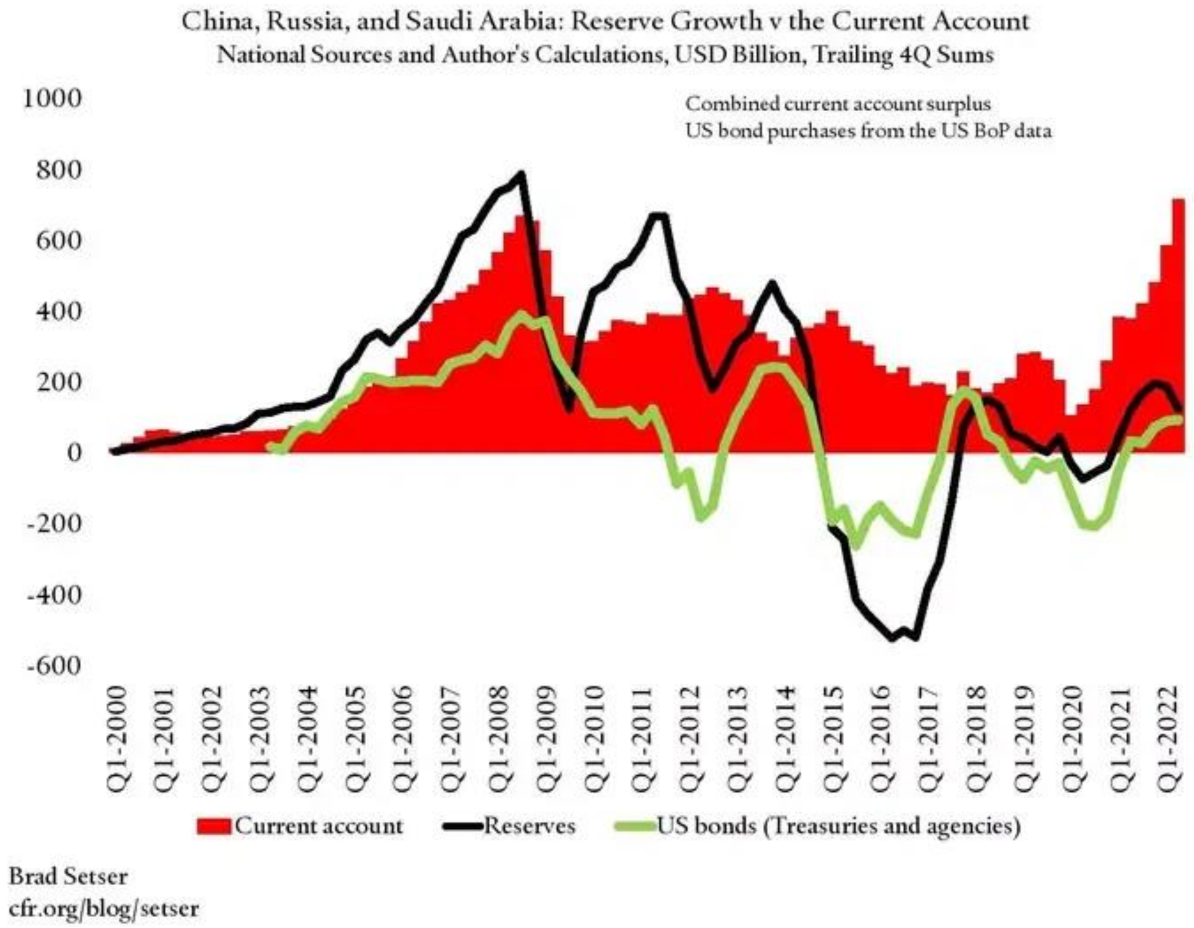
Dramatic increase in CB ownership of sovereign debt



Source: Janus Henderson

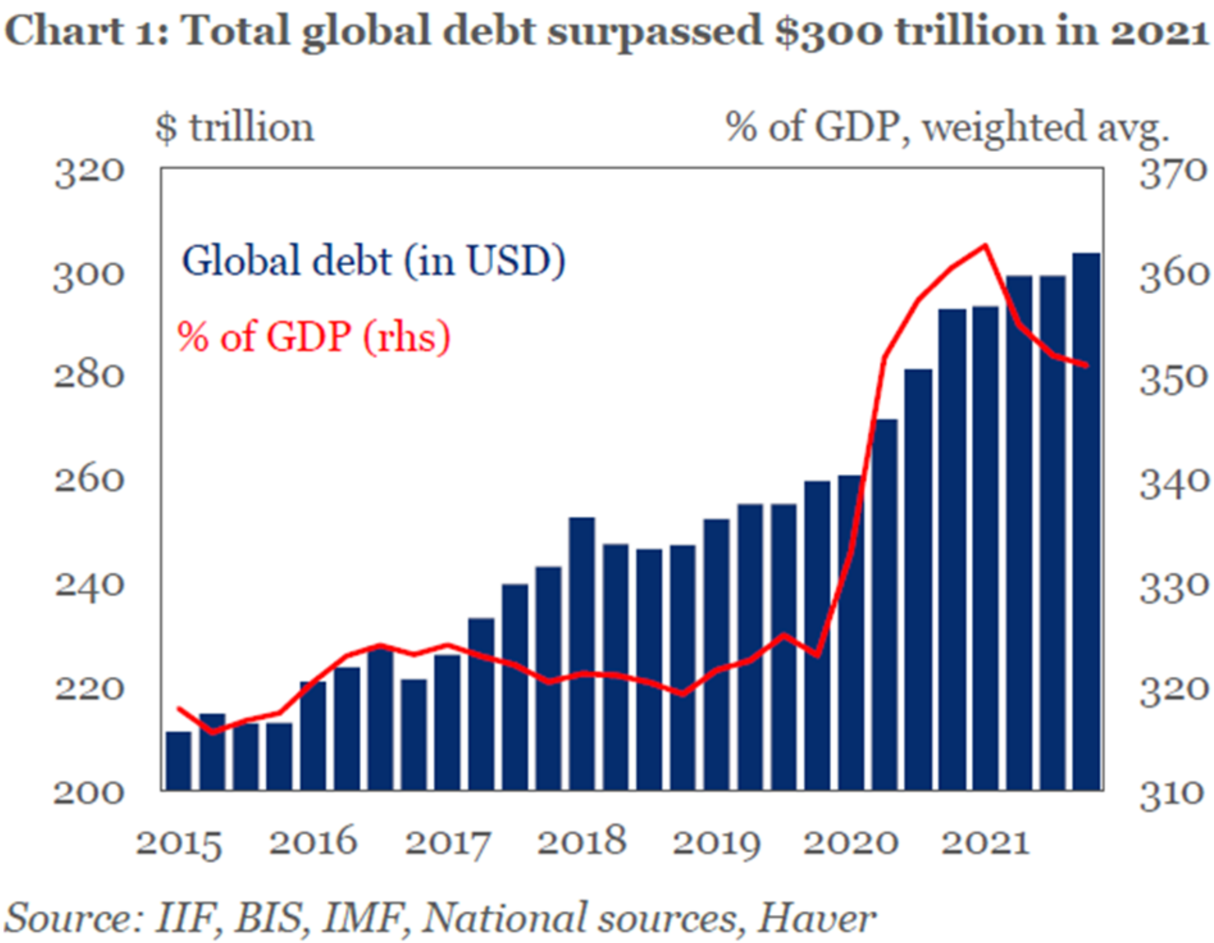
Global imbalances rear their heads again

- Surpluses no longer recycled into USTs



Covid-related debt expansion was a bridge too far

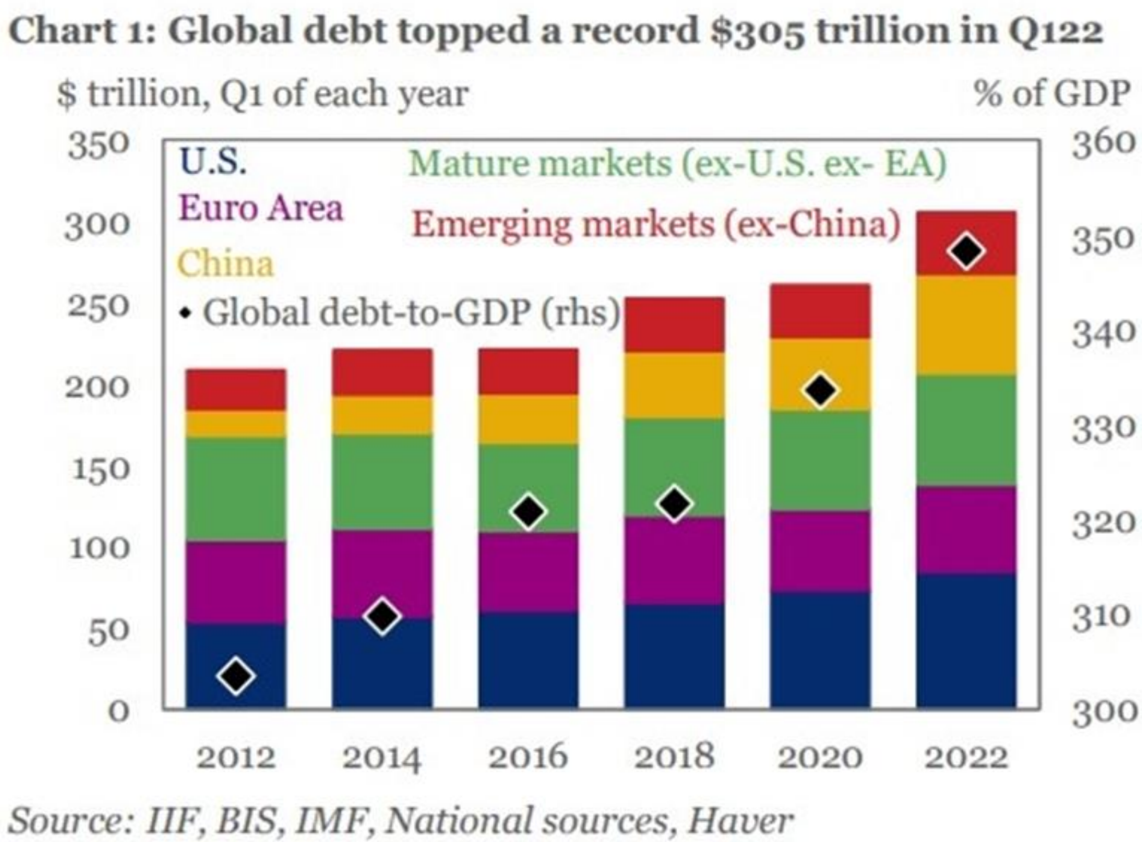
- Central banks forced into monetisation



Economic Perspectives

US and China contributed the most to surging debt

- But global leverage ratio fell 15pp in past year

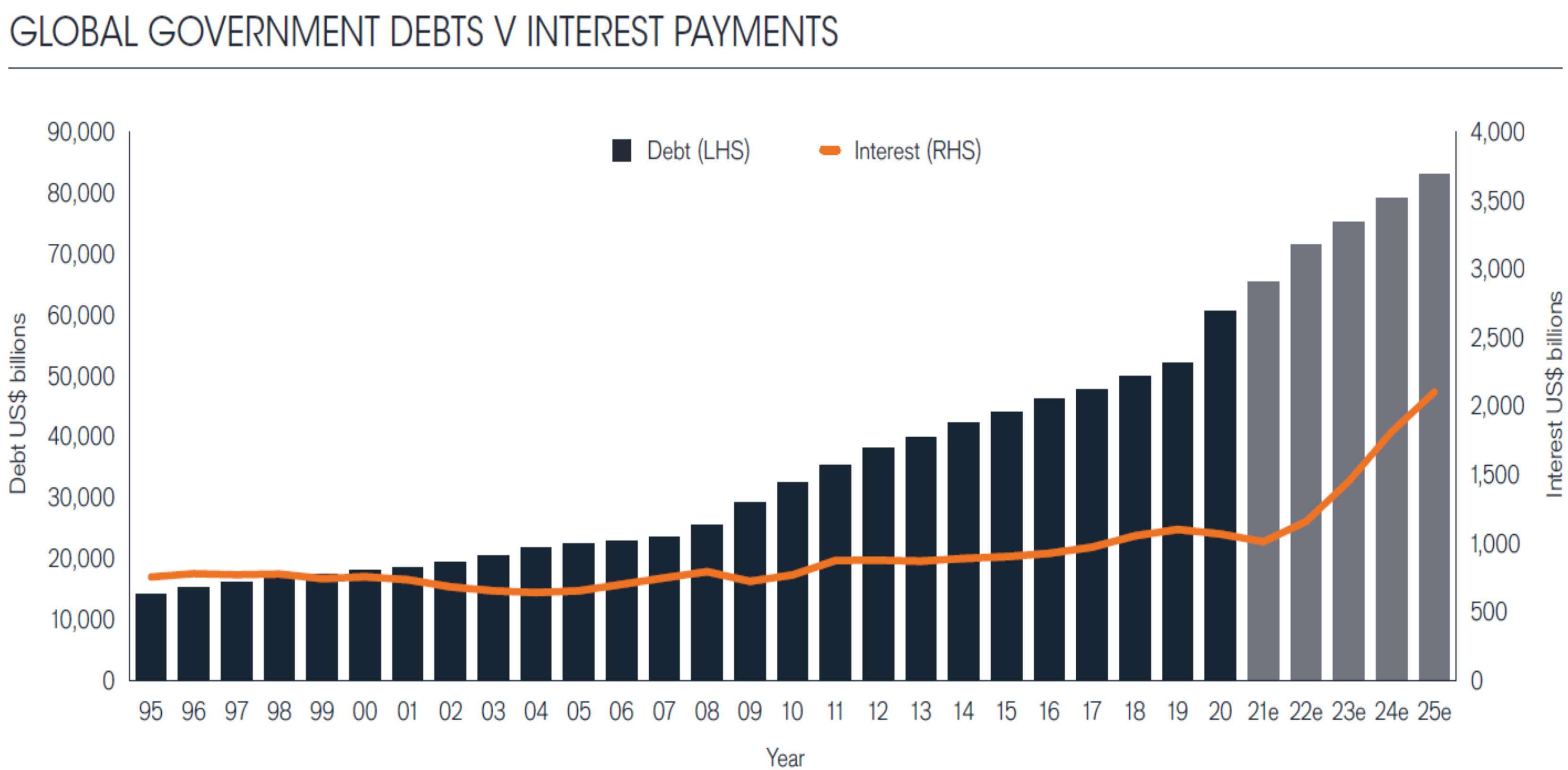


Dramatic escalation in debt service burdens

- Loss of financial discipline during Covid has opened up a can of worms
- Catch-22: governments can't stand aside and allow central banks to wrestle with the inflationary challenge because of the painful consequences for the economy and financial system; but if they curtail CB tightening and spend more on social protection then inflation takes hold
- Rise in public debt service costs is a lose-lose proposition: it obstructs attempts to tame the budget deficit and it reduces the scope for programme spending

Exposing the fantasy of limitless public borrowing

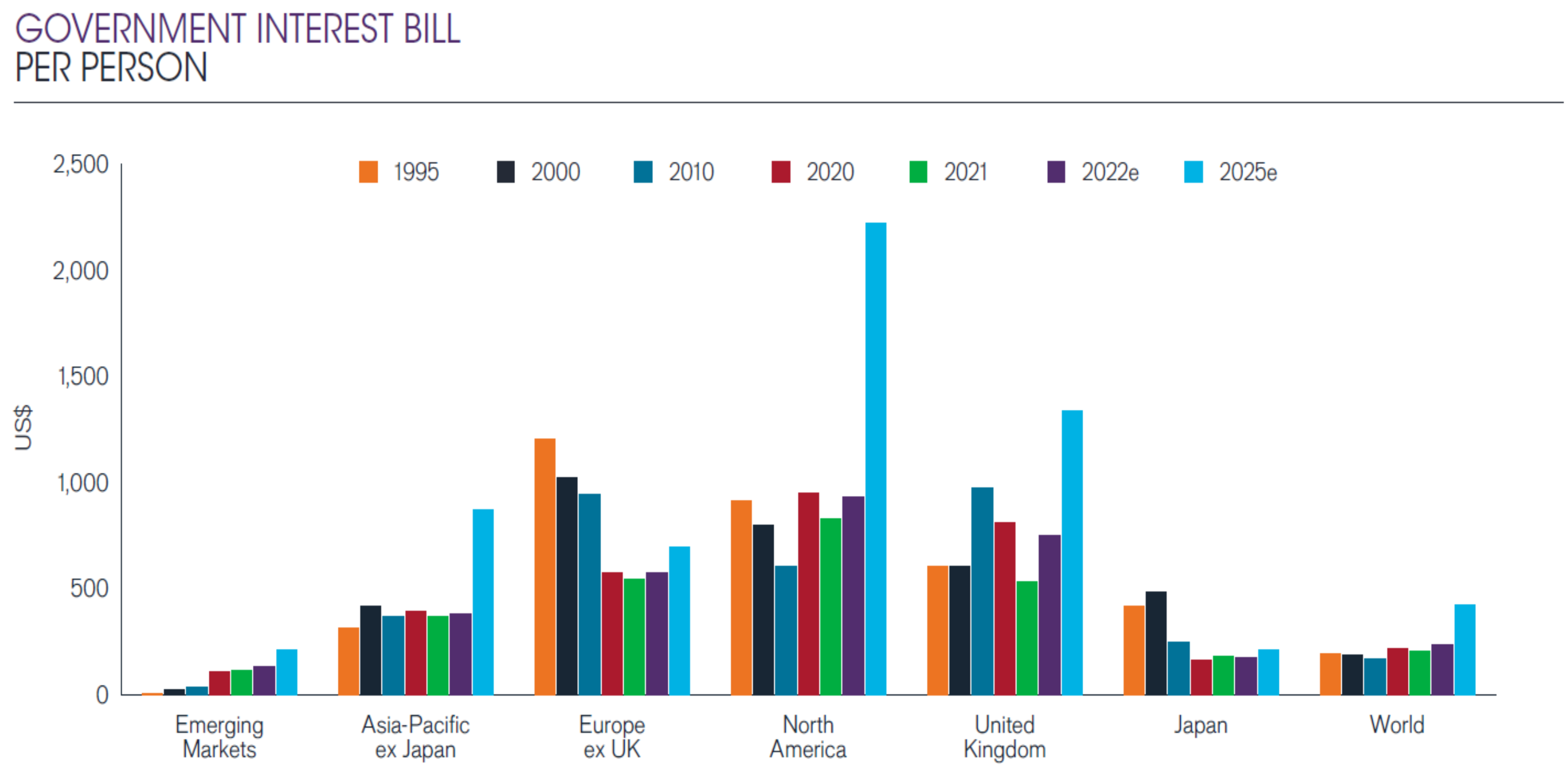
- Servicing costs expected to double in 4 years



Source: Janus Henderson

Japan is best able to restrain debt service costs …

- … and US and UK the least able



Source: EIU, Janus Henderson, March 2022

Economic Perspectives

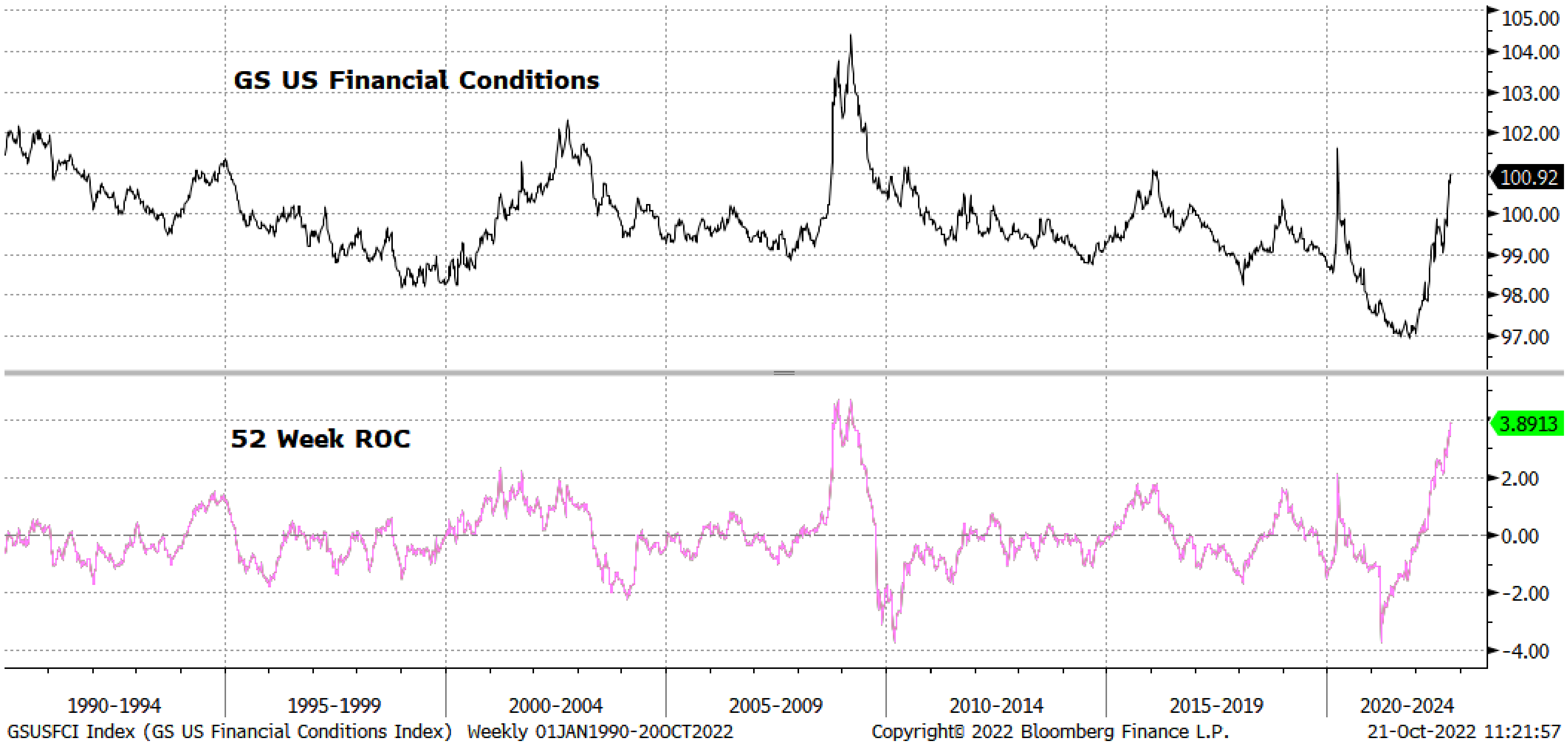
Frightening consensus about falling inflation!

- Much less agreement over falling rates

Recognising the damage to the supply side

- Argument for persistent inflation rests on
  a) the lack of political resolve to mount a successful anti-inflation campaign
  b) the failure of higher prices to call forth additional supply
- Food and agriculture
- Fossil fuel dilemma and resulting underinvestment
- Demographics of truckers and engineers, etc
- Tightness in shipping markets – slow steaming, use of ships as floating storage, lack of investment in LNG vessels, etc.

CBs are steering a course for financial instability



Signs of a crack in the pricing of weakest credits

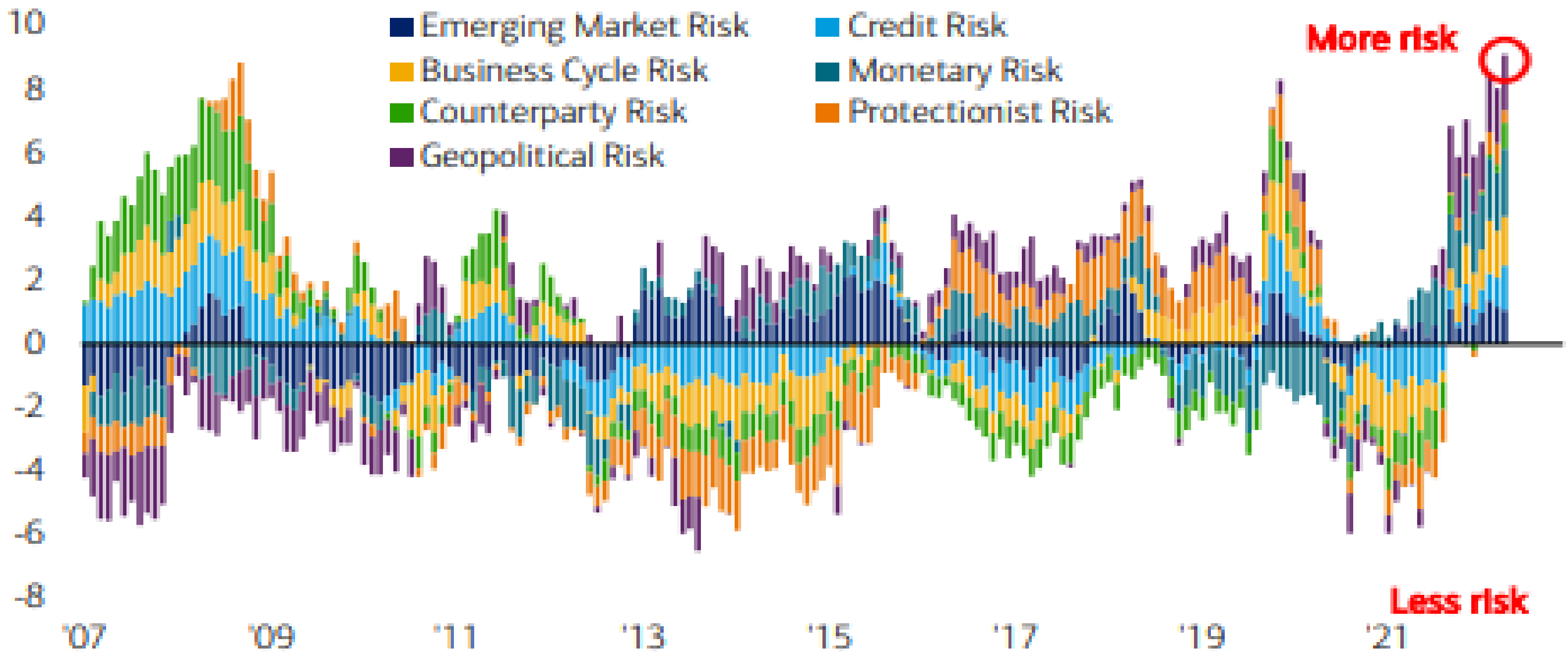
- Is the Fed willing to trigger a fracture in credit?

Economic Perspectives

Risk perceptions have risen markedly

- Geopolitical risk is adding to the mix

Chart 16: Most categories of risk have worsened in October '22 (vs September)
At this time how would you rate these potential risks to Financial Market Stability?



Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

Reasons to expect the Fed to flinch

- Intense political pressure – from right and left
- Too quick to assume that lower gasoline prices will secure low CPI inflation
- Tempting to pick on service sector wage growth as a trigger for halting the hikes
- Prior beliefs of central bankers regarding falling r-star and secular stagnation
- Likely extension of S&P 500 losses prompted by earnings erosion and inflation persistence
- Fear of being blamed for a financial market crisis

Persistent inflation: the radical scenario

- The *de facto* tightening of credit conditions – as lenders shut up shop and borrowers face less attractive terms – and financial conditions raises concerns over financial stability
- Fed is compelled to cut short *both* its programme of funds rate increases and its quantitative tightening
- It no longer has the freedom to pursue its inflation objective. Inflation is unfettered, a free variable in the system
- Structural elements of inflation persist, relating to market structures, demographics and geopolitics

Predictions

- The Fed 'put' will be reinstated once the S&P500 has lost 30%-40% from its highs
- The mounting risk of financial instability will take precedence over near-term inflation control
- The administration will relax the fiscal stance, out of necessity
- Credit spreads will widen appreciably and debt delinquencies and defaults will jump
- Bond price rallies will be powerful, but temporary; UST 10Y yield to peak at more than 5% in 2024-25

Geopolitics>National politics>Economic policy

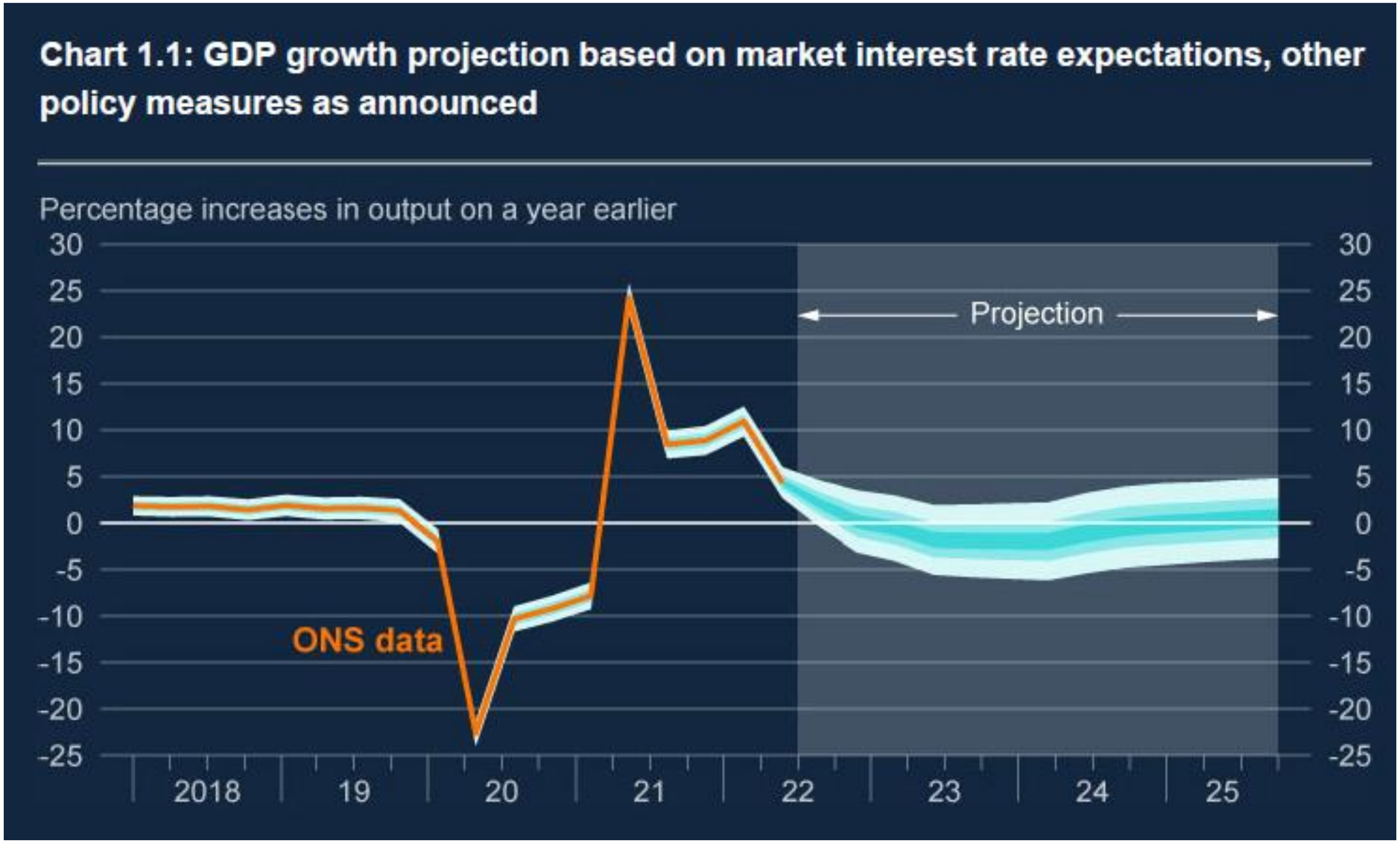
- It's not "The economy, stupid!" – it's the shifting geopolitical landscape and the polarisation of national politics. The government budget has become the primary tool for managing economic outcomes
- Central banks are ciphers in the drama, sometimes appearing to act independently, but politically constrained
- Central bank balance sheets are at the disposal of the political process

UK economic and financial outlook

- Economy has been twisted out of shape by the pandemic and associated policy responses
- Negative supply shocks – to labour participation and to labour productivity – require a drop in aggregate demand if inflation is to fall sustainably
- Autumn Statement has adopted a tighter fiscal stance to reinforce monetary tightening in pursuit of a necessary contraction in activity
- However, government budget is not under good control and Bank may well be required to restart QE to stabilise sovereign bond yields

UK enters 2023 with negative momentum

- H2 2024 credible timescale for recovery



Bank & OBR inflation projections reflect model properties

- Political economy of inflation is disregarded

UK is coping with an idiosyncratic rise in cost of credit

- Waiting for the impact of mortgage rate resets

Chart 2.9: The recent moves in long-term rates have been driven by UK factors

Decomposition of the change in the 10-year UK nominal government bond yield since the start of 2022 (a)

Sources: Bloomberg Finance L.P., Tradeweb and Bank calculations.

(a) Methodology based on Rigobon (2003). Identification of the country-specific origins of shocks is based on asset price volatility over time. The orange 'Global' bars combine identified shocks from the euro area, Japan and US. Data are weekly and the latest data point is for the week to 20 October 2022.

Credit conditions will continue to tighten in 2023 …

- … irrespective of MPC rate decisions

Sources: ICE/BoAML Global Research and Refinitiv Eikon from LSEG.

(a) Option-adjusted spreads relative to government bond yields. Investment-grade corporate bond yields are calculated using an index of bonds with a rating of BBB3 or above. High-yield corporate bond yields are calculated using aggregate indices of bonds rated lower than BBB3. Due to monthly index rebalancing, movements in yields at the end of each month might reflect changes in the population of securities within the indices.

UK corporate credit conditions have tightened

- Deloitte CFO survey

Chart 2. Cost and availability of credit
Net % of CFOs reporting credit is costly and credit is easily available

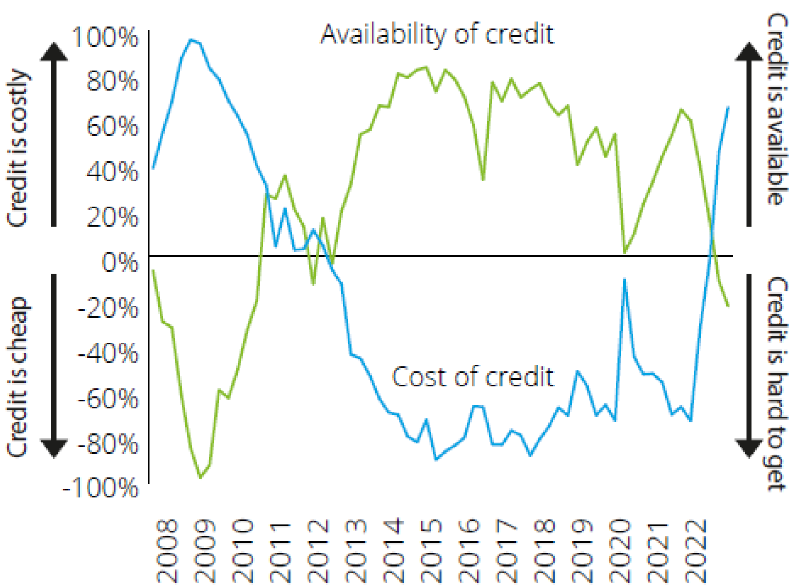
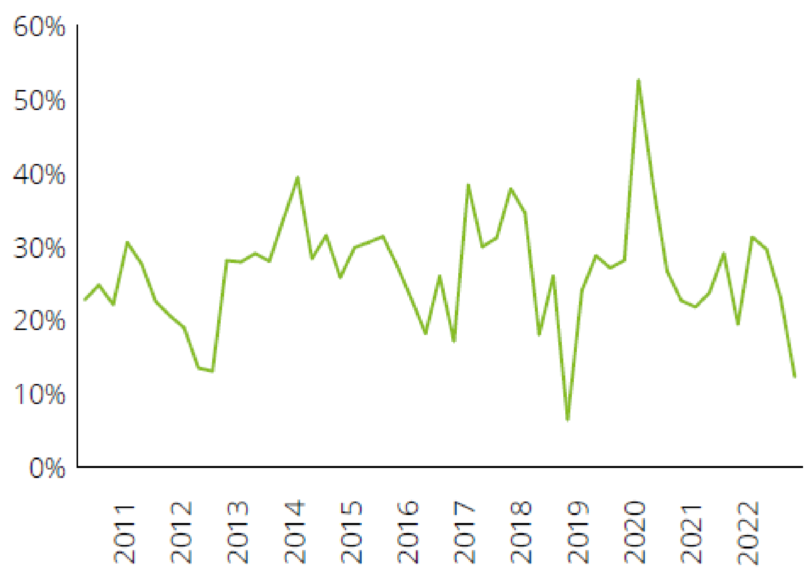


Chart 4. Corporate credit demand
Net % of CFOs who expect their own business's demand for new credit to increase over the next 12 months



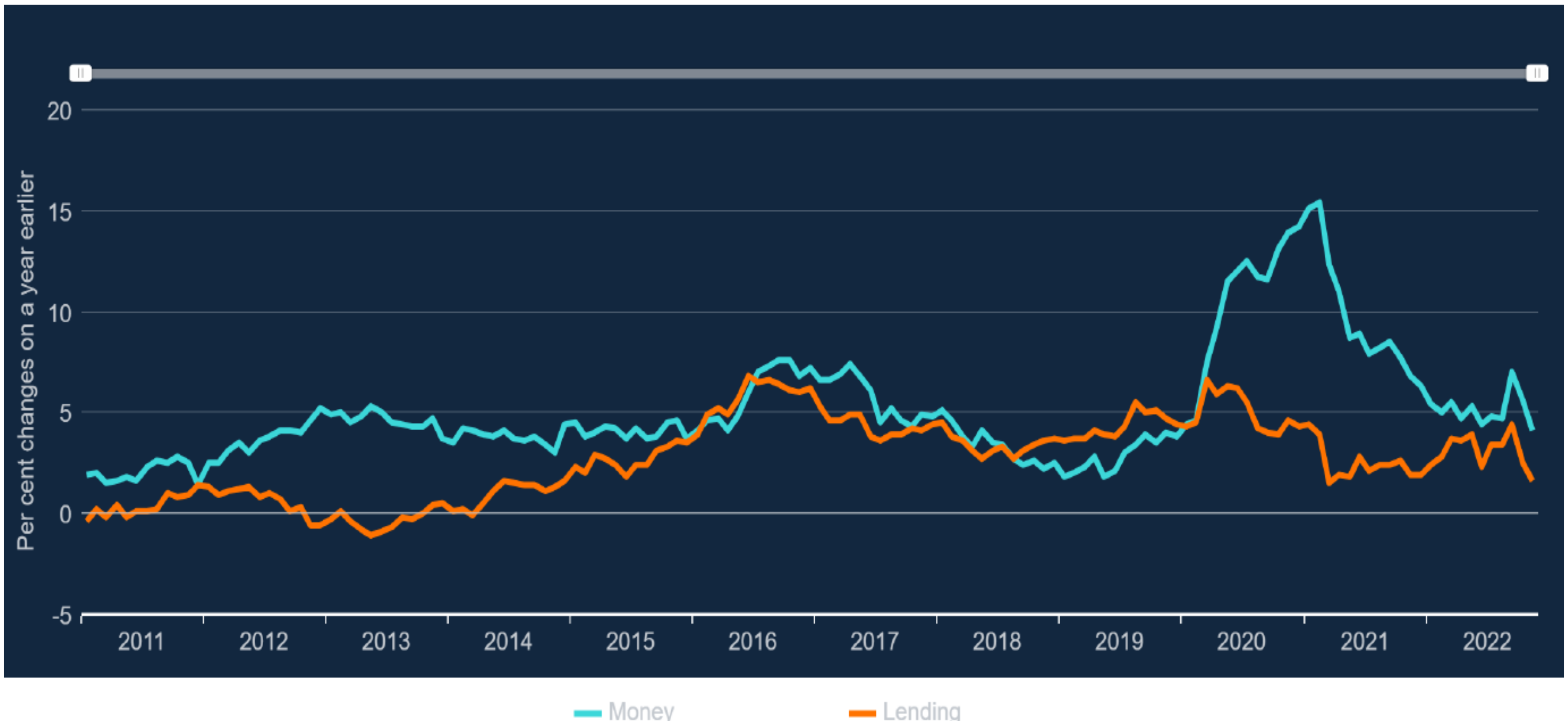
Mortgage resets imply a severe household squeeze

Sources: FCA Product Sales Data and Bank calculations.

(a) Number of outstanding owner-occupier fixed-rate mortgages as at 30 June 2022, distributed by quarter during which fixed-rate period expires and by existing interest rate. These data do not include buy-to-let mortgages or mortgages that are off balance sheet of authorised lenders, such as securitised loans or loan books sold to third parties. Mortgages with less than £1,000 outstanding are excluded.

UK money and credit in sharp real contraction

- How low will we go?



Economic Perspectives

Peter Warburton

Peter@EconomicPerspectives.co.uk
+44 1525 792144
www.EconomicPerspectives.co.uk