Markets look for early UK rate hikes

Inflationary pressures continue to mount across the globe as evidenced by spiraling energy costs, as well as growing supply bottlenecks and labour shortages. Economies are struggling to cope with meeting the surge in demand that has followed the lifting of Covid-19 restrictions. Markets have become more volatile as they start to price in monetary tightening by central banks to contain the threat to price stability.

It is noteworthy that the greatest market concerns around inflation would appear to relate to the UK, as reflected in the recent rise in bond yields. Ten year benchmark yields have risen by around 30bps points since late August in both the US and Eurozone. The rise has been much more pronounced in the UK, with ten year Gilt yields rising by circa 60bps over the same period.

The UK suffered the deepest recession of the major economies as a result of the Covid-19 pandemic, with GDP declining by almost 10% last year. Thus, one would have thought that the UK would be one of the last countries expected to raise rates as the economic recovery gets going. Far from it, though, as the UK is the only major economy that markets foresee implementing a series of rate hikes over the course of next year.

Indeed, the Bank of England is expected to begin raising rates early in 2022, with two 25bps increases priced in by mid-year and close to another 25bps hike anticipated by year end. By contrast, markets are looking for just one 25bps hike from the US Fed at end 2022, while rate increases are not expected to commence in the Eurozone until mid-2023.

The risks to price stability, though, are more acute in the UK than most other countries. Despite the deep recession, the labour market appears to be tighter than elsewhere. The disruptions to supply chains also seem greater as evidenced by fuel shortages and concerns around supplies of many goods. There is little doubt that the dislocations to supply chains, trade and labour markets, caused by the pandemic, have been amplified by Brexit.

The response of the UK government to the labour shortages is that wages need to rise, rather than relying on immigration, to boost employment. Without an accompanying rise in productivity though, this could give rise to a wage-price spiral, especially given the disruptions to supply chains, with the economy already facing considerable pent-up demand.

The forecasts are for the UK economy to slow sharply in 2023 as the surge in demand abates and monetary and fiscal policy are tightened. GDP growth is projected at below 2% from 2023 onwards. The BoE expects inflation will have fallen back to around target by then. Hence, after hikes in 2022-23, markets see UK rates levelling off at circa 1% post 2023.

Sterling has been remarkably stable given the different forces buffeting the UK economy. It has remained within a very tight range against the euro since February. Normally firming rates should be supportive of a currency. However, rising inflationary pressures can weigh on a currency, especially if excessive demand triggers a rising balance of payments deficit. Given the high level of uncertainty, sterling traders have remained on the side lines. However, history has shown that sterling is capable of big moves in a short period of time.

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