DTRE DOES... THE ECONOMY

ECONOMIC PREVIEW – JANUARY 2022

KEY POINTS

1) Omicron will hit GDP, with a 0.9% month-to-month drop in December. Don't expect the economy to recover until February
2) Sluggish household spending is the main drag on UK GDP
3) Interest rates will probably reach 0.75% by end 2022

Omicron, the latest Covid variant threw a spanner, albeit hopefully only temporarily, into the UK's recovery prior to Christmas. Now we have come out the other side it's becoming clear that the path ahead remains mixed, with talk of a decade of the 'roaring 20s', similar to that experienced in the 1920s post World War I, firmly off the table for now.

Prior to the discovery of the new variant the outlook for the UK economy was already mixed, with the strong recovery predicted earlier in 2021 slowing to a crawl, as inflation and supply chain worries dampened consumer spending.

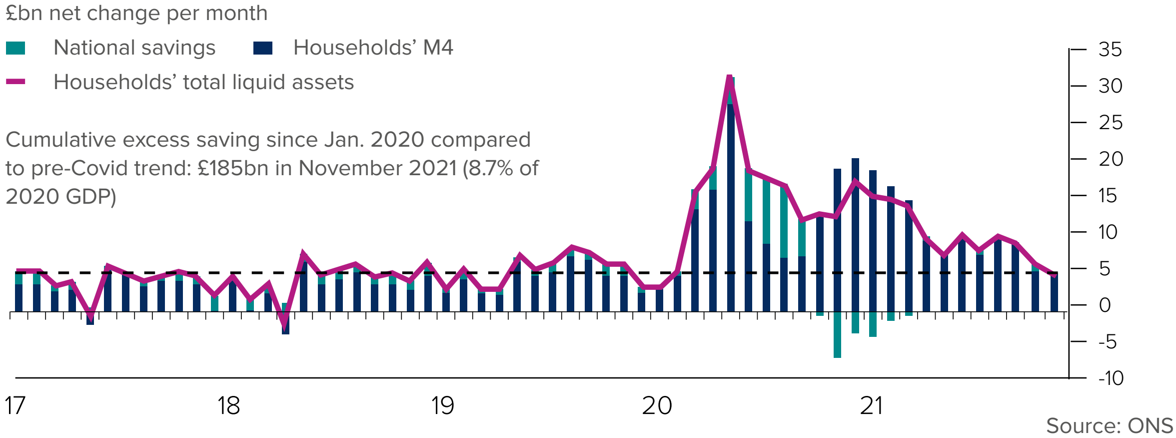
The latest GDP numbers released last week (Fri. 14th Jan) for November showed the economy did have some momentum prior to the emergence of Omicron. GDP rose by 0.9% month-to-month in November and the three-month-on-three-month growth rate increased to 1.1%, from 0.9% in October. This increase in November also pushed the level of GDP 0.2% above its pre-Covid peak, which is estimated to have occurred in October 2019.

However, moving forward, GDP is almost certain to fall in December given the amount of isolation, both forced and voluntarily, as people attempted to avoid socialising in the run-up to Christmas to spend time with their families. As a result, GDP probably fell by 0.9% month-to-month in December, therefore fully reversing November's increase, with economists forecasting a further 0.3% drop in January.

Even after the worst of the Omicron wave has passed, however, the economy will struggle for momentum, and we are unlikely to shake off this apathy because real household disposable income looks set to fall by just over 1% in 2022.

In April, households will be hit by a near-40% rise in Ofgem's energy price cap, which will lift CPI inflation to an eye-watering 6% and wages will not keep up with inflation, despite the tightness in the labour market. The latest 'Money and Credit' Report for November did show households returning to more normal pre-Covid spending patterns, with bank deposits and savings falling to levels last seen in January 2020, and secondly, consumer lending rose by £1.2B in November, also matching the average increase between 2018 and 2019, and double its average in the prior six months (see Fig 1).

Fig 1. Households have been saving much more than usual every month



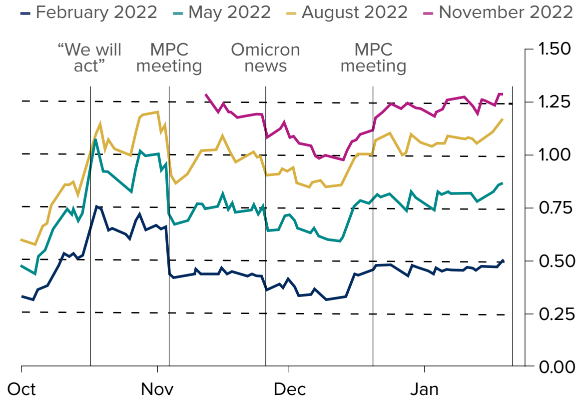
Source: ONS

Looking ahead, it's doubtful that this twin draw down on savings and increase in consumer lending is an indication of consumers currently loosening the purse strings, particularly with consumer confidence still bumbling around in the minus numbers.

It's probably more a reflection of households doing their best to maintain their current level of consumption in response to surging consumer price inflation and reflecting the earlier than normal purchase of Christmas presents. Further to this much of this cash eventually will be spent on imports that households have foregone over the last 18 months, such as cars or foreign holidays and therefore don't expect to see a lift to GDP.

Fig 2. UK instantaneous nominal forward curve (overnight index swaps)

Level of bank rate at upcoming MPC meetings implied by OIS rates, bp



Source: Bloomberg

The other component of GDP that is struggling is exports. Exports were 14% below their 2018 average level in Q3, and the consensus across economists is that it is doubtful they will return to their 2018 level until 2024. Exporters have lost market share, due to Brexit, with uncertainty over the longevity of the deal, and the UK's trading relationships with other countries continuing to deter firms from making Britain their export base. In comparison imports likely will rebound in 2022, particularly as we return to taking foreign holidays. However, the result will be that net trade levels will continue to dampen GDP growth.

One positive is business investment, which looks set to rebound to pre-Covid levels by Q3 2022, (much quicker than in previous downturns). Firms' balance sheets are in good shape, profit margins are healthy, and some businesses are capacity constrained. The Chancellor's "super-deduction" policy also will spur firms to invest before April 2023. The recent weakness of business investment also has been due to supply chain dislocations, which now seem to be weakening, gradually.

Finally, on interest rates Pantheon Macroeconomics don't see a scenario where rates are hiked as often as the market currently suggests over the next 12 months (see Fig 2). The market, as implied by overnight index swaps, implies rates hiking to 1% by August (see yellow line), however Pantheon states, "We expect the MPC to hike the Bank Rate to 0.75% in May 2022". Thereafter, sluggish domestic demand, for the reasons I've laid out above will ensure high inflation doesn't become embedded and therefore the MPC will be able to take it's time rather than be forced to tackle persistent high inflation by raking up rates higher and higher.

DTRE

www.dtre.com

WRITTEN BY

Robert Taylor
020 3328 9106
robert.taylor@dtre.com

DTRE
2nd Floor, Coin House
2 Gee's Court, London W1U 1JA