

International Commentary — January 26, 2022

U.K.: Slower Growth, Faster Inflation, Gradual Tightening

Summary

- The U.K. economy is displaying increasingly divergent trends. CPI inflation has continued to trend higher, reaching 5.4% year-over-year in December, and could peak as high as 6.5% to 7.0% before inflation begins to recede. In contrast, U.K. activity growth is likely to experience temporary softness around the turn of the year related to a surge in COVID cases, and face headwinds from reduced consumer purchasing power later in 2022.
- While elevated inflation will clearly warrant further Bank of England tightening in our view, subdued growth suggests those rate increases will be delivered at only a gradual pace from the U.K. central bank. **Specifically, we expect the Bank of England to hold its policy rate steady at 0.25% at its early February monetary policy announcement.** More broadly, we forecast a cumulative 50 bps of Bank of England rate hikes over the next year, well below that currently expected by market participants.
- This more gradual view of Bank of England tightening is an important influence behind our view of a weaker pound over time. We forecast for a softening in the GBP/USD exchange rate towards \$1.2900 by the end of 2022, and to \$1.2700 by the middle of 2023.

Economist(s)

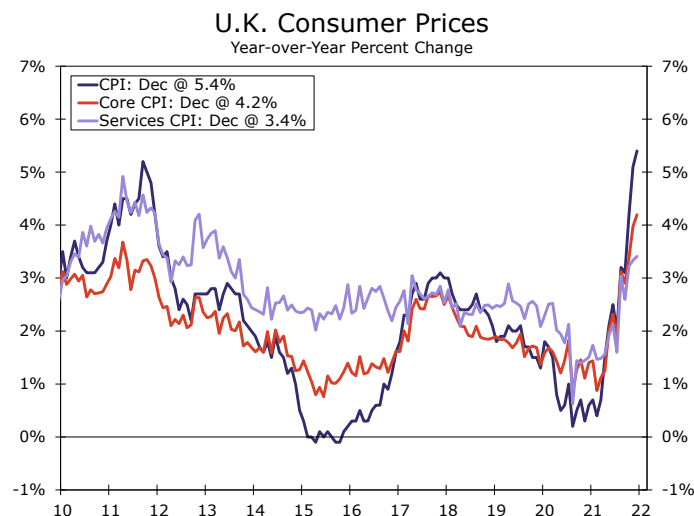
Nick Bennenbroek

International Economist | Wells Fargo Economics
Nicholas.Bennenbroek@wellsfargo.com | 212-214-5636

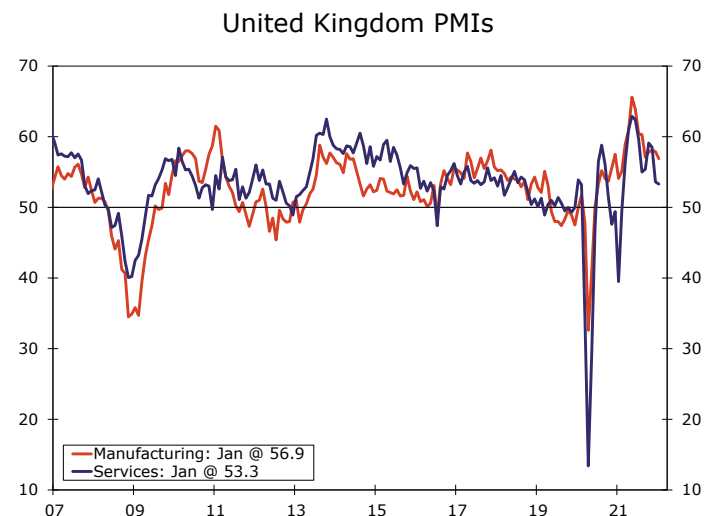
You Take the High Road...

U.K. data releases since the start of this year have offered further insight into increasingly divergent economic trends. On the price front, the December CPI showed that inflation continues to quicken and, indeed, surprise to the upside. Headline inflation firmed more than expected to 5.4% year-over-year, while the core CPI unexpectedly quickened to 4.2%. Survey data indicate that price pressures will persist for the time being, with the input and output price components of the PMI surveys remaining near record highs. However, in the manufacturing sector, an improvement in supplier delivery times at least hints at some easing in supply disruptions.

Another factor which points to elevated inflation continuing in the near-term is another increase in electricity prices scheduled for April this year. Higher prices for gas and electricity have been important drivers of faster U.K. inflation, with December year-over-year increases of 28.1% and 18.8%, respectively. In contrast, services CPI inflation, while not exactly tame, rose a lesser 3.4% in December. Still with the looming April electricity price rise, the overall rate of U.K. CPI inflation is likely to climb into a 6.5% to 7% range. Even if a significant portion of the spike of U.K. inflation is energy-driven, overall price increases of that magnitude will clearly warrant and necessitate further policy rate increases from the Bank of England, with the main question being the timing and speed of those central bank rate hikes.



Source: Datastream and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

...And I'll Take the Low Road

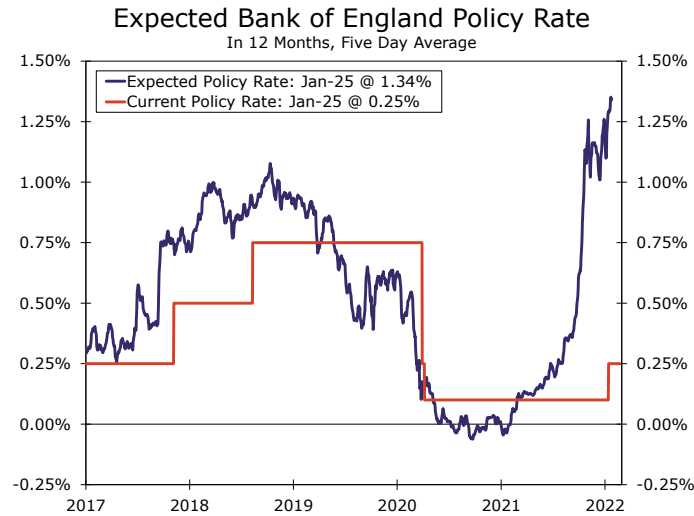
With respect to the pace of monetary tightening, we believe the other significant U.K. trend—that of slower activity growth—will be consequential in seeing the Bank of England deliver only a gradual pace of interest rate increases during 2022. The U.K. economy had displayed decent momentum until late last year, with November GDP for example rising by 0.9% month-over-month. However, as COVID cases surged during December, prompting the imposition of some modest restrictions and voluntary caution on the part of consumers, activity softened markedly around the turn of the year. Most notably, retail sales slumped 3.7% month-over-month in December. Early this year the January manufacturing and service sector PMIs fell further, to 56.9 and 53.3, respectively.

While it is true any COVID induced slowdown in the economy will likely be short-lived, with cases having receded in recent weeks, the looming increase in electricity prices will also weigh on consumer purchasing power, and should also be a headwind for the economy in the months ahead. As a result, we believe the outlook remains for somewhat uneven and relatively moderate U.K. economic growth in 2022. We forecast GDP growth of 4.1% for 2022, down from an estimated 7.1% in 2021, though we believe the risks around that growth outlook remain tilted to the downside.

It is against this backdrop that we expect the Bank of England will thread the growth and inflation needle by delivering only a gradual pace of interest rate increases during 2022. **Specifically, we expect the Bank of England to hold interest rates steady at 0.25% at its February 3 monetary policy announcement.** More broadly, **we forecast only two 25 bps rate increases this year, at the May and**

November announcements, and two more 25 bps rate increases in 2023. We also expect the Bank of England will wait until 2023 before it starts to reduce the size of balance sheet.

Should the Bank of England follow the gradual path we suggest, it should see the GBP/USD exchange rate come under pressure over time. An "on hold" decision from the Bank of England in February would disappoint relative to expectations from market participants, which have almost fully priced in a 25 bps rate hike for February. Moreover, the 50 bps of policy rate increase we forecast from the Bank of England over the next 12 months compares to market expectations for 113 bps of policy rate increase over that period. **This more gradual view of Bank of England tightening is an important influence behind our forecast for a softening in the GBP/USD exchange rate towards \$1.2900 by the end of 2022, and to \$1.2700 by the middle of 2023.**



Source: Bloomberg LP and Wells Fargo Economics

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

The 2022 Annual Economic Outlook: Restoring Balance in the Post-Pandemic Economy is available at wellsfargo.com/economicoutlook

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Mark Vitner	Senior Economist	704-410-3277	Mark.Vitner@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	704-410-1437	Sara.Cotsakis@wellsfargo.com
Jessica Guo	Economic Analyst	704-410-4405	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. ("WFBNA"). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., Wells Fargo Securities Canada, Ltd., Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation offer or solicitation with respect to the purchase or sale of any security or other financial product nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report. The views and opinions expressed in this report are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company. © 2022 Wells Fargo Bank, N.A.

Important Information for Non-U.S. Recipients

For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority ("FCA"). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. ("WFSE"). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE