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Pound's Problems Likely to Persist For Now

Economist(s)

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Summary

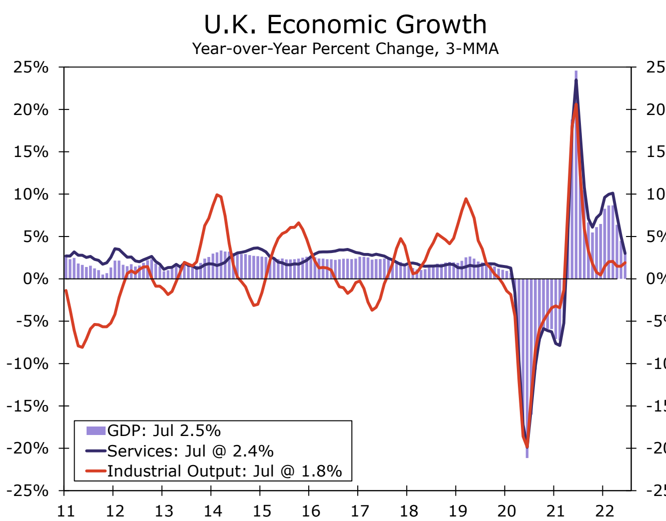
- The latest report card on U.K. economic activity reveals that growth is still lacking in momentum, while labor market trends have also started to soften. With wage gains still not keeping pace with inflation, we still expect a mild U.K. recession as declining real household incomes weigh on consumer spending.
- However, that recession could be shorter and shallower than previously forecast. The U.K. government announced plans to cap energy prices for households for up to two years, and also provide support to business, which should result in a lower peak in inflation and a smaller contraction in GDP. **We now forecast a smaller decline in U.K. GDP of 0.5% in 2023, and a slightly stronger rebound in 2024 of 2.2%.**
- Against this backdrop, we remain comfortable with our forecast path of moderate U.K. monetary tightening. **We expect the Bank of England to raise its policy rate 50 basis points to 2.25% at next week's monetary policy announcement, and follow up thereafter with a 50 basis point rate increase in November and a 25 basis point increase in December, which would see the Bank of England's policy rate peak at 3.00% by the end of this year.**
- **With Bank of England tightening set to lag the Fed and fall short of market expectations, we expect renewed downside in the pound. We see the GBP/USD exchange rate falling to $1.1200 or below by late 2022/early 2023.** Thereafter, as the U.S. economy also falls into recession and the Fed reaches the end of its tightening cycle we expect some rebound in the pound, to $1.1500 by the end of 2023.

U.K. Economic Backdrop Remains Less Than Stellar

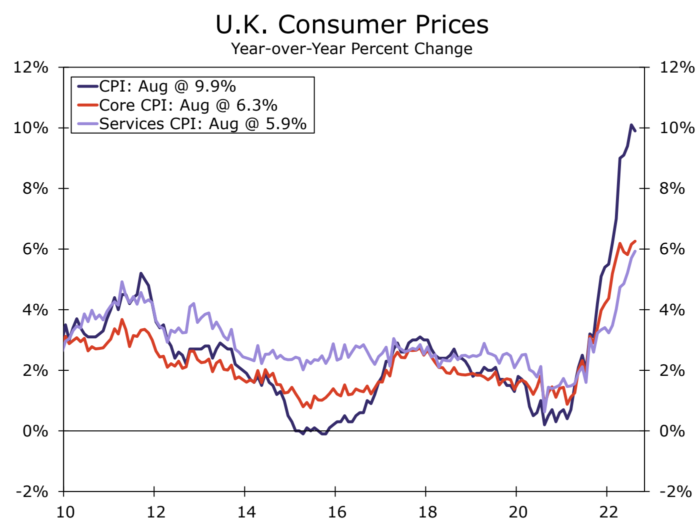
The British currency has come under significant pressure over the past several weeks and, in early September, fell close to our forecast medium term low for the GBP/USD exchange rate. More recently the pound has enjoyed some relief, enjoying a sizable bounce through the middle of this month. A natural question therefore is whether the worst has passed for the pound, or if the most recent gains reflect a "false dawn". Overall we believe the U.K. currency still faces challenges and is likely to re-test, and indeed fall through, prior lows.

The latest report card on broader U.K. economic activity reveals that growth is still lacking in momentum. U.K. July GDP rose 0.2% month-over-month, slightly below the consensus forecast and reversing only some of the 0.6% decline in June. Growth in the service sector was slightly more encouraging with a gain of 0.4%, but economy wide growth was held back by a 0.3% decline in industrial output and a 0.8% fall in construction output. In terms of the very short-term outlook for U.K. GDP, we note that service sector activity is likely to take a hit in September due to the extra public holiday that has been scheduled in observance of the passing of Queen Elizabeth II. As a result for the third quarter as whole we expect zero GDP growth, on the heels of a flat quarter in Q2.

The lack of economic momentum has started to weigh on labor market trends, and we still believe that household fundamentals will contribute to a mild U.K. recession over time. Employment growth for the May-July period relative to February-April period slowed to just 40,000, the smallest increase since February this year. And while average weekly earnings for the May-July period were up 5.5% year-over-year, wage increases are still not keeping pace with inflation, with the CPI rising 9.9% year-over-year in August. Out outlook remains for a moderate decline in real household disposable income which will restrain consumer spending, and see overall GDP contract starting in late 2022 and through the first half of 2023.



Source: Datastream and Wells Fargo Economics



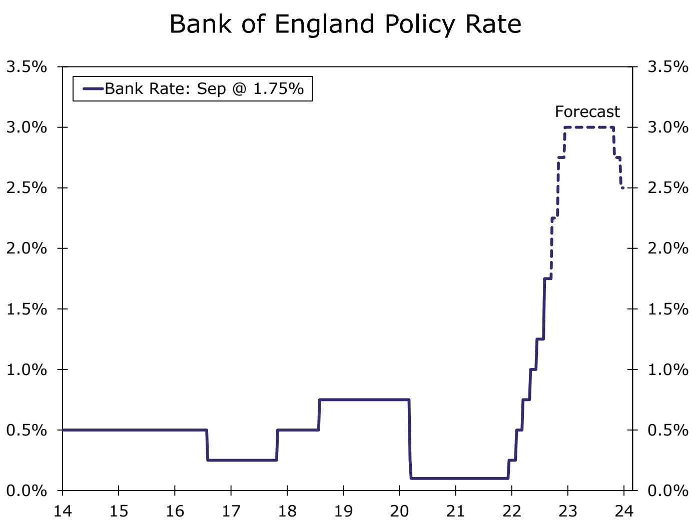
Source: Datastream and Wells Fargo Economics

Medium-Term Growth Outlook Has Turned Less Negative

Separately, there have also been developments on the economic policy front in recent weeks that will likely affect the medium-term outlook for the U.K. economy. Early in September, new U.K. Prime Minister Liz Truss announced plans to cap electricity and natural gas prices for households and businesses. So far the most comprehensive details are available for the plans relating to households, with the government planning to freeze energy bills for up to two years. From 1 October, energy costs for households will be capped at £2,500 per year, well below the £3,549 cap that had previously been announced by U.K. energy regulator OFGEM. The government estimates the effect of preventing the full pass through of recent and future wholesale energy price increases will reduce CPI inflation by 4 to 5 percentage points. The government is also scheduled to shortly announce equivalent support measures for businesses for an initial period of six months.

The cost of the energy support plans will likely be substantial at potentially well over £100 billion (or 4% of GDP), though it represents fiscal support that will offer some assistance to the economy, with real household disposable incomes set to come under less pressure than previously anticipated. With some moderate further quickening of inflation still expected it is not clear the announced measures will see the U.K. avoid recession, but it should make any economic contraction shorter and shallower. Based on the details announced so far, our best assessment is the U.K. is now likely to contract for only three quarters starting in Q4-2022, as opposed to the four quarter recession beginning in Q4 that we previously forecast. Moreover, in terms of our full year GDP growth forecasts we now expect a smaller 0.5% decline in 2023 (previously 0.9%) and a slightly stronger 2.2% rebound in 2024 (previously 2.0%).

While still far from ideal, this mix of a lower peak in inflation and a smaller contraction in GDP could prove less challenging for Bank of England (BoE) policymakers. The lower inflation peak could reduce the pressure for the BoE to keep aggressively raising interest rates for an extended period especially if, as we expect, the U.K. still falls into a mild recession. Against this backdrop, we remain comfortable with our forecast path of moderate U.K. monetary tightening. We expect the BoE to raise its policy rate 50 basis points to 2.25% at next week's monetary policy announcement, and follow up thereafter with a 50 basis point rate increase in November and a 25 basis point increase in December, which would see the Bank of England's policy rate peak at 3.00% by the end of this year. We expect the Bank of England's policy rate to remain steady through much of 2023, before a modest 50 basis points of easing from the U.K. central bank in Q4 next year.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

From a currency perspective, we believe this economic and policy mix is consistent with renewed weakness in the pound through until early 2023. Our outlook for Bank of England rate hikes contrasts with the more aggressive path of tightening expected by the Federal Reserve. It also falls well short of rate hikes currently priced into markets, which anticipate a peak in the Bank of England's policy rate near 4.50% around the middle of 2023. As the Bank of England lags the Fed and falls short of market expectations, we expect the GBP/USD exchange rate to come under renewed pressure, falling to $1.1200 or below by late 2022/early 2023. Thereafter, as the U.S. economy also falls into recession and the Fed reaches the end of its tightening cycle we expect some rebound in the pound, though with the U.K. facing its own economic challenges that rebound should be modest, We forecast a GBP/USD exchange rate of $1.1500 by the end of 2023.

Wells Fargo International FX Forecast

Currency Pair	Q3-2022	Q4-2022	Q1-2023	Q2-2023	Q3-2023	Q4-2023
GBP/USD	1.1400	1.1200	1.1200	1.1300	1.1400	1.1500
EUR/GBP	0.8600	0.8575	0.8650	0.8675	0.8775	0.8875

Source: Wells Fargo Economics

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