

UK Macro: A view from financial markets

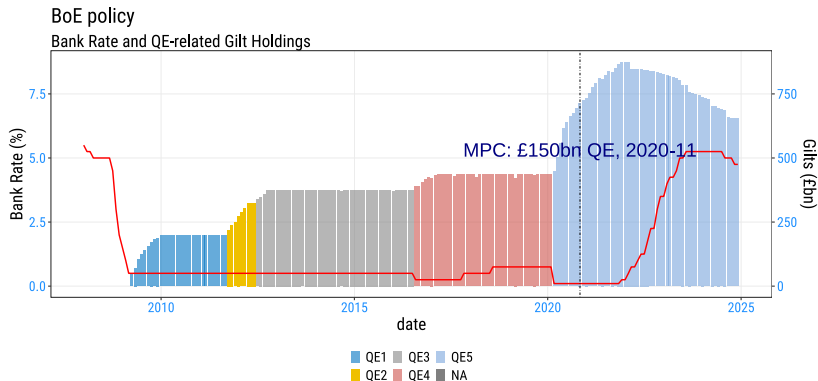
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January 1, 2025

Key Questions

- ▶ How is the UK economy **evolving**?
- ▶ How is the UK's **policy mix** evolving?
- ▶ Where might we be going badly **wrong**?

BoE Policy Settings



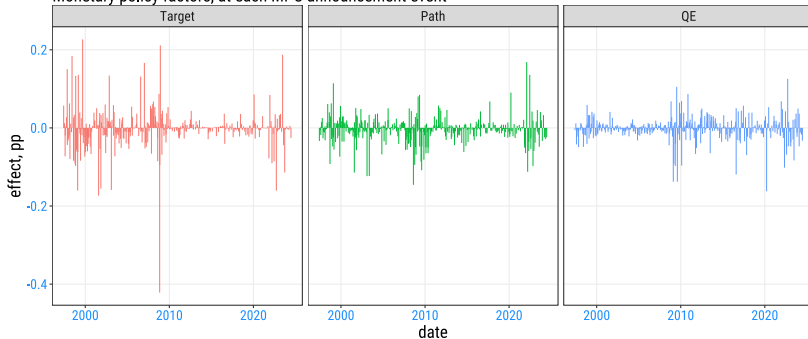
Source: BoE

- ▶ QT to date reverses the GBP150bn QE decision [Nov 2020], in terms of BoE Gilt holdings.
- ▶ Start of rate hiking cycle delayed by the 12m and pre-announced QE programme.

Evolving forms of Monetary Policy

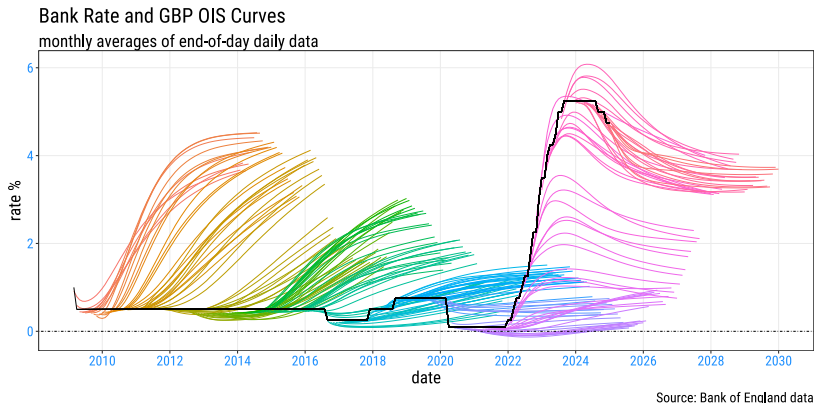
Evolving BoE Monetary Policy Factors

Monetary policy factors, at each MPC announcement event



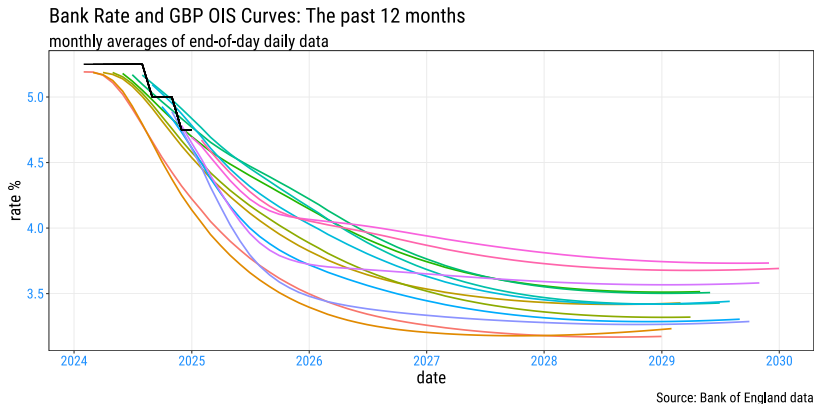
Source: UK Monetary Policy Event Study Database (UKMPD)

Evolving Market expectations



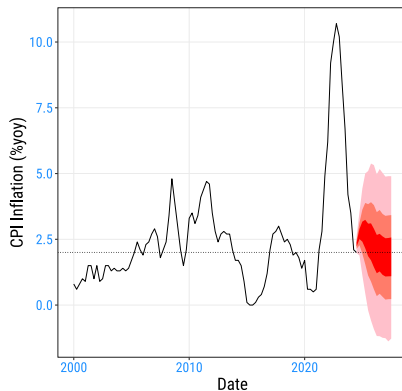
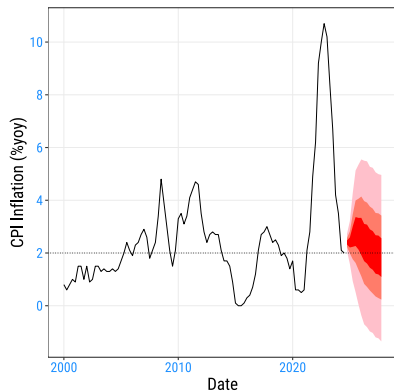
- Learning about hard-to-learn features of the economy (eg productivity and 'trend' growth) can be slow (Farmer *et al*, 2024).

Zooming in... the past year



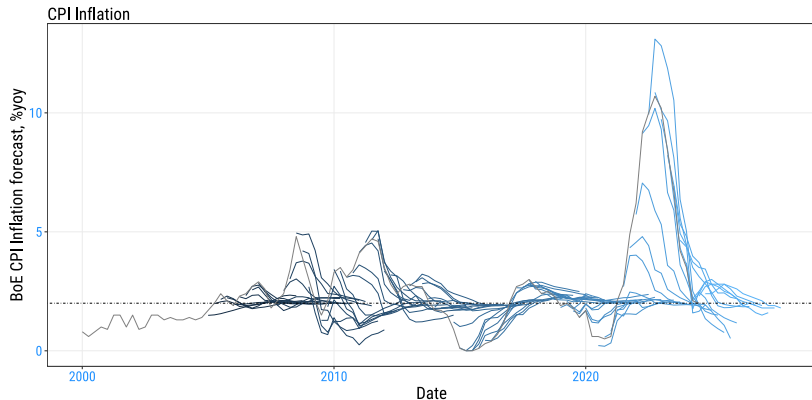
- Expected rate cuts have moderated... despite faster than expected disinflation in the past year.

An evolving inflation outlook?



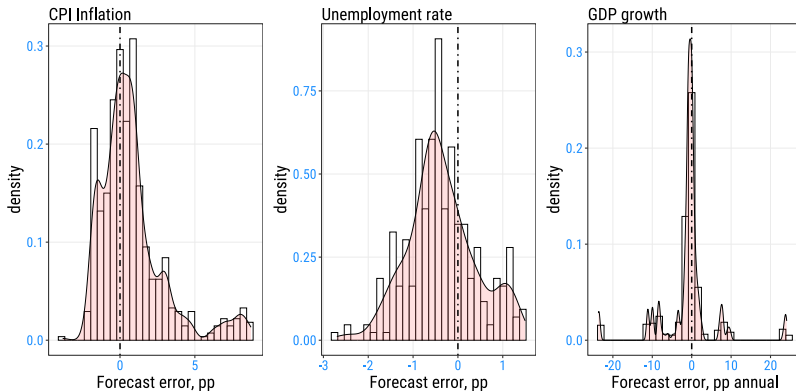
- ▶ BoE's Fan charts say little about the scale, persistence and source of macro news – about 'how is the economy evolving?'

Macro news: scale, persistence of source of news



- Policy framework broadly robust to its largest inflation shock.

The pattern of BoE forecast errors

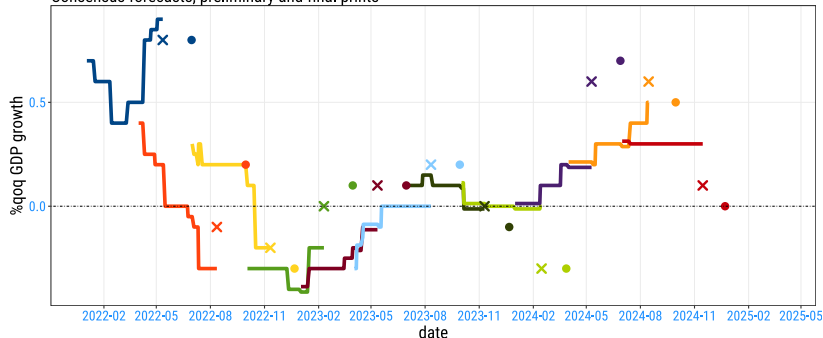


- Pattern of forecast errors points to repeated, negative supply shocks. (CPI: higher-than-expected; U: lower-than-expected; GDP: unbiased).

GDP Growth – Evolving expectations and out-turns

UK GDP Growth (%qoq) - Evolution of Consensus Forecasts

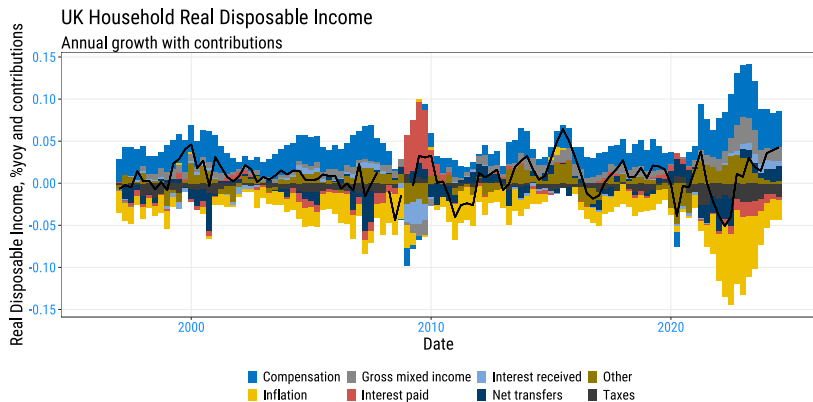
Consensus forecasts, preliminary and final prints



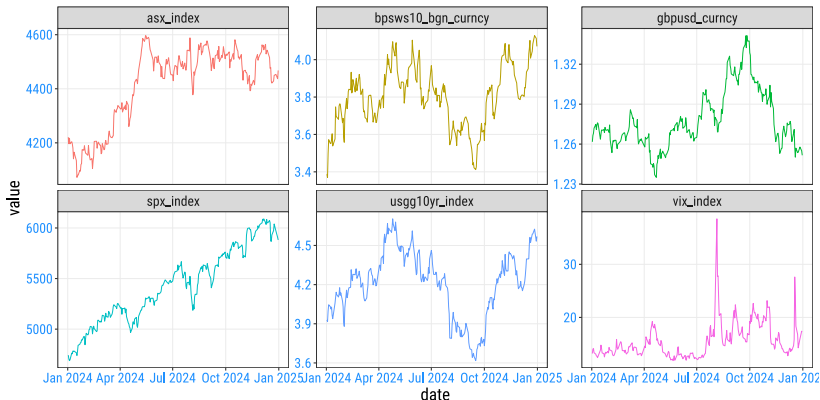
Source: Bloomberg

- Medium-term growth: innovation and reallocation dominate capital deepening.

Household real incomes

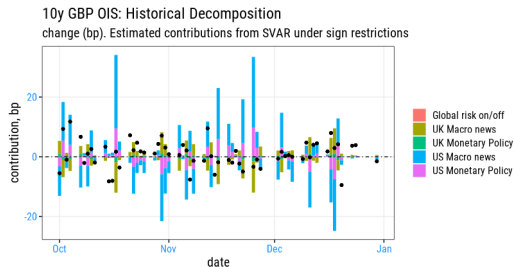


Sterling asset prices



- Aim: distinguish sources of news: (i) UK macro (ii) BoE Monetary policy news (iii) US macro (iv) Fed policy and (v) Risk-on.

Decomposing changes in asset prices into macro

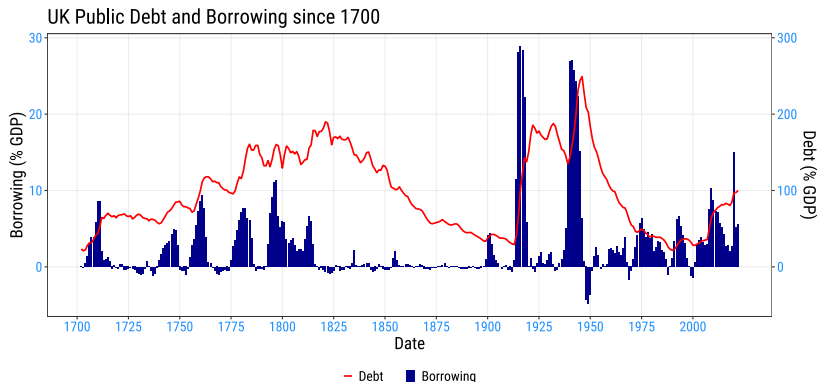


- ▶ Results from a Bayesian VAR estimated under sign restrictions on daily, financial market data.
- ▶ OIS higher on US spillovers.

Domestic inflation and the labour market

- ▶ A restrictive monetary stance takes time (2y) to moderate wage growth and core inflation with some cyclical improvement in labour productivity and profits.

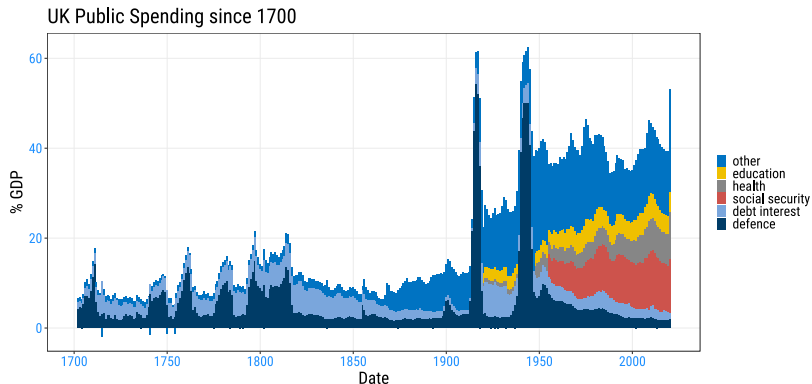
Worsening fiscal arithmetic: a public debt ratchet



Source: OBR

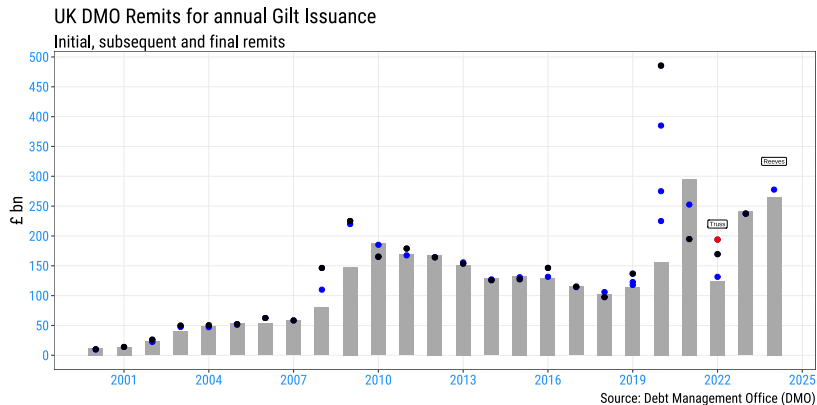
- ▶ One-off Supply shocks should be met with *higher* Public Debt, worked-off gradually.
- ▶ Yet: $r \uparrow$, $g \downarrow$ imply a *lower* optimal Debt/GDP ratio.

Public spending shouldered by bond-holders + tax-payers



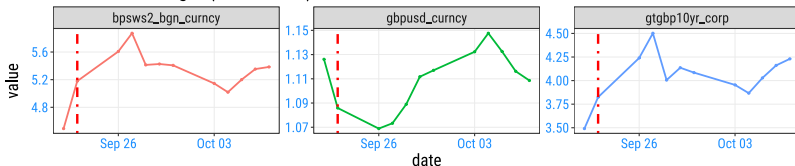
- ▶ The bond market understands that politicians can be inclined towards making Bond-holders, not Tax-payers, shoulder Public spending.

Debt Issuance approaching its limits?

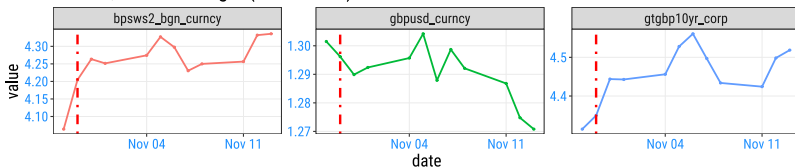


Truss vs Reeves: financial markets' assessment

Truss, mini-Budget (2022.09.23)

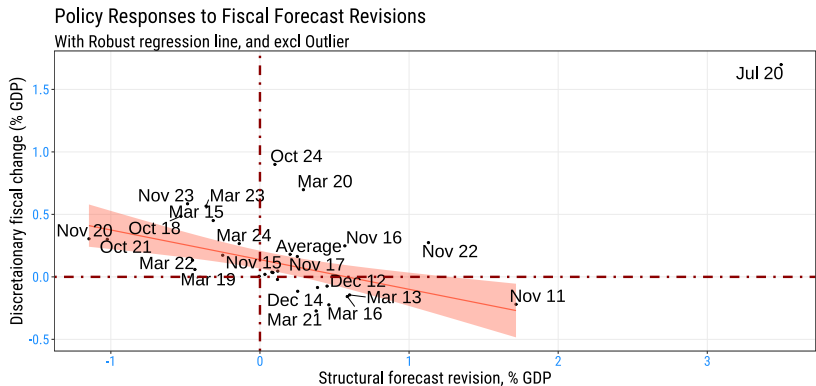


Reeves, Autumn Budget (2024.10.30)



- ▶ **Truss:** a loss of (foreign) **investor confidence**, exacerbated by long-term investors (LDI). BoE interventions stabilised.
- ▶ **Reeves:** a more standard injection of **aggregate Demand**, met with higher ST interest-rates. A subsequent deterioration in aggregate Supply?

Asymmetric fiscal choices ?

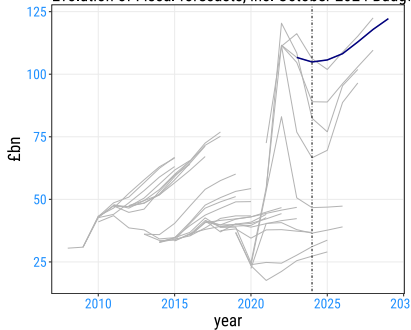


- ▶ Spending proceeds of good news rather than 'paying-down' debt in good times, despite ratchet higher in Debt/GDP.
- ▶ Estimates of 'Headroom' (vs. loosened fiscal targets) are small.

$r \uparrow, g \downarrow$

Debt Interest Costs

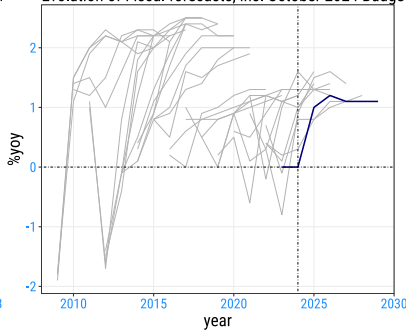
Evolution of Fiscal forecasts, incl October 2024 Budget



Source: OBR

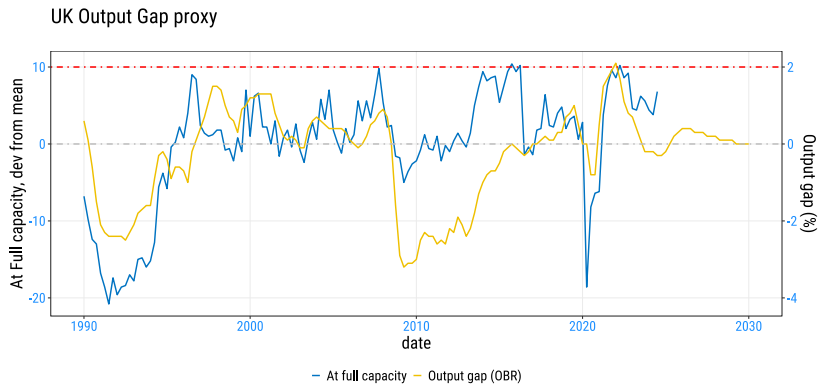
Labour Productivity forecasts

Evolution of Fiscal forecasts, incl October 2024 Budget

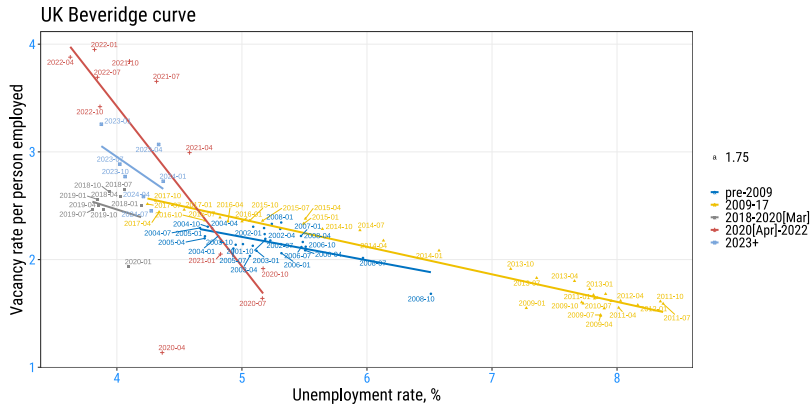


Source: OBR

g_{\downarrow} and y^* may be lower than thought

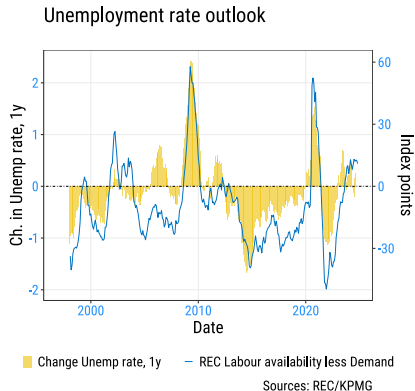
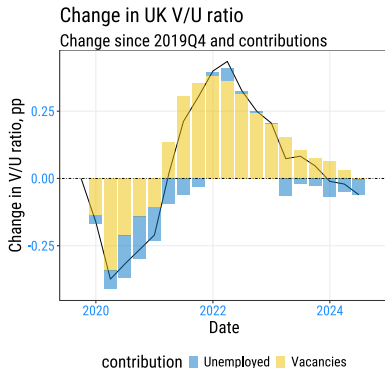


Source: BCC, OBR



► pre-Covid vs. latest U/V curve suggests an outward shift.

Rising unemployment



- Risk: U^* is mis-interpreted as a cyclical effect.
- Would imply some additional inflationary pressure, pushing up on 'r' over time.

What have we learned?

- ▶ **Learning** how the data are evolving, while still **reassessing the starting point** + what we thought we could take as given.
- ▶ **Bayesians**: learning is continuous. But sometimes we have to unlearn something, previously taken as given. Imagine: jumping to a different branch of a decision tree.
- ▶ **Policy**: needing to reassess the starting point is the origin of big policy mistakes. In **Markets**: opportunities from these discontinuities (a la *Big Short*).
- ▶ *UK Examples*: (i) BoE underestimating a positive output gap, post-Covid in 2022, with 'incrementalism' since then. (ii) BoE and markets assuming unrealistic fiscal tightening in 2024H1. Forward curves drift higher since then.

Conclusions

How is the UK economy evolving? Ongoing disinflation, depends on a restrictive monetary policy stance.

How is the UK policy mix evolving? Withdrawal of monetary restriction and fiscal support slower than thought a year ago. Fiscal policy as a driver.

Where might we be going badly wrong?

- Both Debt sustainability and Inflation persistence are sensitive to over-stating supply capacity and its trend.
- Excess demand if improved terms of trade and labour supply boost Demand more quickly than Supply; more so, if this is mis-diagnosed as a boost to Supply, as U rises (for structural reasons).
- **Risks:** If consumers already discount fiscal consolidation, while monetary policy eases (Hawkish)? And/or, has transmission of past monetary tightening been delayed (Dovish)?