CIO Viewpoint

Facing up to the UK's post-pandemic, post-Brexit challenges

Investment Solutions

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The UK's booming economy faces rising inflation with fewer tools to manage growth as it deals with shortages, an uncertain job market, higher manufacturing and energy costs. Post-pandemic, post-Brexit Britain is looking to invest in structural solutions without overheating the economy. The UK's challenges are not unique, but Brexit uniquely limits the country's options in the years ahead.

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After experiencing the sharpest economic fall among G7 countries in 2020, the UK saw one of the strongest rebounds this year, in part a mechanical function of re-opening businesses and services. It is expected to register gross domestic product growth of 6.8% for 2021, and another 5% in 2022, according to International Monetary Fund estimates released last week.

When the Chancellor Rishi Sunak unveils the UK's next budget on 27 October, the Treasury is expected to cut spending on government while lifting total taxes to their highest levels since the 1980's. In the meantime, public spending is on course to be around GBP 20 billion, or around 25%, lower than forecast in March.

Mr Sunak has also promised new fiscal rules to limit public spending over the next few years and cap the country's debt to GDP at around 100%. In contrast, in 2020 the European Union agreed a EUR 800 billion 'next gen' pandemic rescue and investment deal, and the US has a USD 3.5 trillion fiscal package planned.

Price pressures

Rising inflation is making the Chancellor less enthusiastic about additional fiscal stimulus as a 1% rise in interest rates would wipe out his margin for spending, he said in March. The Bank of England (BoE) has said that it expects inflation to reach 4% by the end of this year and is preparing to raise interest rates. The BoE's guidance is that it will not begin to unwind its bond purchases until its reference rate reaches 1.5%.

Higher energy prices and supply-chain shortages add to the UK's inflationary pressures over the coming months as widespread labour shortages and higher costs reach consumers. The UK recorded a rise in inflation of 3.2% in August compared with a year earlier, marking a nine-year high and more than one percentage point above than the central bank's 2% target.

Key takeaways

- The UK's recovery is being tested by rising inflation and longer-term Brexit-related issues
- This month's government budget statement is expected to limit public spending
- The BoE is expected to start raising interest rates in response to higher inflation
- We keep our overweight position in UK stocks as the recovery favours banking and energy names. Rising bond yields and high prices also offer support.

"Monetary policy cannot solve supply-side problems," BoE Governor Andrew Bailey said on 17 October, "but it will have to act and must do so if we see a risk, particularly to medium-term inflation and to medium-term inflation expectations." Policymakers therefore find themselves faced with the risk of slowing the UK's growth, before the economy has fully recovered from the Covid pandemic.

Two-year and ten-year inflation swaps, which reflect bond investors' price expectations, are trading at more than 5% and 4% respectively (see chart), compared with current gilt yields of 0.5% and 1.1%. The yield on the UK government's 10-year gilts reached a high of 1.22% a week ago, as investors have already priced-in an interest rate hike from 0.1% to 1% by the end of 2022. That implies investors are willing to accept a deeply negative real yield.

UK RPI inflation swaps

Source: Bloomberg

'Fundamental change'

In common with the rest of the world, the speed of the UK's recovery in demand has outpaced supply. The additional difficulty for the UK through Covid has been a net loss of workers. One study estimates that as many as 1.3 million people left the UK during the pandemic, including EU nationals. Brexit and its changed immigration rules may mean that many now stay there.

"We expect that both the pandemic and Brexit have fundamentally changed patterns of migration in and out of the UK," the Office for National Statistics wrote last month. Historically, the UK's economy was able to make use of a flexible labour market that counted on European workers to respond to its economic cycles.

Petrol and pork

In recent weeks the focus has also been on petrol shortages, blamed on a lack of truck drivers to deliver it rather than a lack of fuel at refineries. Between mid-2020 and March 2021 the number of EU citizens working as lorry drivers in the UK fell 14,000, or more than one third to 25,000, out of a total 229,000 drivers. As early as 2018, the Bank of England's Monetary Policy Committee noted that growth in supply would be subdued by low jobless rates, leaving little room for increasing output without boosting inflation.

This month's budget may include further steps to accelerate work visas for skilled migrants for 'high-growth' firms and graduates of a 'top global' university as part of the government's narrative about 'pragmatic controlled immigration.' In the shorter term, the government has already offered truck drivers and butchers fast-track temporary visas in an effort to ease supply-chain problems ranging from petrol to pork.

Prime Minister Boris Johnson recently told a BBC interviewer that the UK was going through "an extremely interesting moment." His government is re-drawing shortages as a global problem and a sign that the UK is already transitioning to a higher wage, higher productivity economy. The nation's shortages in abattoirs and on the roads are because companies relied on "low wage, low cost, immigration for a very long time," the prime minister said. There is also a European-wide shortage, and the Times newspaper reported that there have been 27 tanker-driver applicants from the EU for the 300 positions advertised.

Pounds and equities

From a currency perspective, the effects are mixed. Expectations of higher interest rates should support sterling over the next three-to-six months. We expect euro-sterling to trade around 0.8450 over this period. Once the rate hikes have kicked-in however, curbing growth, markets will shift focus to the negative impacts of Brexit on UK trade, weakening demand for the currency.

We retain our overweight exposure to UK equities. Most internationally focused British firms remain relatively insulated from the domestic labour shortages and supply-chain turmoil. UK indices, which contain large numbers of banking and energy firms, are also benefitting from the cyclical rebound. Rising bond yields and higher gas and oil prices offer further tailwinds for the country's stocks, reinforced by strong earnings momentum.

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