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Special Coverage:

Omicron doesn't deter BoE from hiking rates

Key takeaways

- The Bank of England raised policy rate by 0.15% to 0.25% amid the omicron variant outbreak to combat inflation.
- The market reaction has been quite muted. Sterling rose half a percent and gilt yields moved higher. Equity markets were up, with financials the top performing sector, and real estate the weakest.
- We remain neutral on UK equities but overweight on UK High Yield bonds. In equities, we prefer to take risk within the US and Eurozone, where there is less fiscal headwind and uncertainty regarding trade.

Jonathan Sparks, CFA
Chief Investment Officer, UK & CI, Global Private Banking and Wealth, HSBC

What happened?

- After the Fed's more hawkish move, the Bank of England (BoE) and European Central Bank (ECB) have followed by announcing a tightening of policy. The BoE voted 8-1 to raise the policy rate by 0.15% to 0.25%. The BoE now reasons that "provided the incoming data, particularly on the labour market, were broadly in line with the central projections in the November Monetary Policy report, it would be necessary to increase the Bank rate over coming months in order to return CPI inflation sustainably to the 2% target. Recent economic developments suggest that these conditions have been met."

- This came as a modest hawkish surprise to the markets which thought there was enough uncertainty around the surge in the omicron variant for the BoE to resist rocking the boat. The BoE didn't hide from omicron, reducing their forecasts for Q4 GDP by 0.5% to 0.6%. Therefore, by the end of the year, the UK economy will still be around 1.5% below the pre-crisis levels.

- The ending of the furlough scheme in the UK went without a hiccup which gives the BoE more confidence to judge that there is more tightness in the labour market. The BoE forecasts the unemployment rate falling to 4% this quarter amid robust demand.

- There is also more concern that inflation expectations have moved higher to the point that they are feeding into higher prices and wages. If this continued to play out, then the outlook for medium-term inflation would rise further. All of these considerations pushed the BoE to act.

- The ECB also sees more inflationary pressure, increasing their forecast for 2022 to 3.2%, far higher than the 1.7% forecast in September's meeting. In reaction to the greater risk on inflation the ECB announced a steeper taper of the Pandemic Emergency Purchase Programme (PEPP), now ending in March. To soften the blow, the ECB announced a monthly net purchase pace of EUR40bn in Q2 2022 and EUR30bn in Q4 2022. From Q4, the existing EUR20bn per month will still continue "for as long as necessary".

Expectations and slack

- What really matters to central banks is the medium-term outlook for inflation. Because of this, energy prices are often something that can be "looked through" since shocks to prices tend to be short term. UK energy inflation is currently running at an annual rate of 26%, while in the US it is closed to 34%. While the price of oil is probably past its peak, gas prices are still sky-high in the UK, having risen a fraction under 5x since the beginning of the year. With energy prices so high, the BoE expects inflation to peak at 6% early next year. We also expect inflation to peak at 6% in April and then fall to 3% at the end of 2022 and 1.8% at the end of 2023.

- Meanwhile, goods prices have risen at an annual rate of 6.5% - double the rate of services inflation. Goods prices are typically more volatile; even more so given the clear supply chain shortages that the BoE's sources in industry suggest should last well into mid-2022 and possible as far as 2023 and 2024. Again, supply chain shortages should tick the transitory box and consequently could be brushed aside. As for omicron, it adds uncertainty but the impact on inflation could work in either direction according to the BoE: it can affect "the balance of demand and supply", but the impact on "medium-term global inflationary pressures is unclear". The concern is now that, such is the persistence of both the supply chain squeeze and energy shortage, expectations are beginning to move higher.

- Demand in both the UK and Europe remains strong, helped by still low interest rates and savings accumulated over the pandemic. The recipe of higher inflation expectations, robust demand and tighter labour markets together has been enough for such a decisive vote to raise rates.

Market considerations

- On a sector level, we have positioned for a rocky ride on inflation going into early 2022. For this reason, we have been **overweight financials, which outperform on high rates** as they can gain from higher loan profits. We expect inflation to peak around April next year for the UK, and then expect it to ease and the policy rate to peak at 0.75%. For the ECB rate hikes have been kicked into late 2022 at the very earliest, and we don't have any hikes in the foreseeable future in our forecasts.

- **We are more cautious on the UK market** partly because of the heightened uncertainty the UK is facing. We prefer to take risk in the Eurozone and the US, and benefit from their economic recovery. It is also because of the more pronounced squeeze on real incomes that we expect domestically oriented UK stocks could be hurt more.

- The market sees central banks acting early but the extent of the total tightening over the cycle is little changed. Structural headwinds, such as high debt levels are not going away and this means that the longer run rate profile is still depressed. In this climate, and amid a mid-cycle recovery in economic growth, **we still broadly favour equities overall but with a neural position on the UK. We see more value in the UK High Yield bonds.** The yield pick-up is attractive, and during a mid-cycle recovery, we would expect credit defaults to remain low.

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