MONTHLY ECONOMIC INSIGHT

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Last month all eyes were on what markets thought would be the first post-pandemic policy change from the Bank of England. However, with rates left on hold we'll take a look at the factors behind the decision and what the data has shown since. And while it's been days since the world learned about 'Omicron', we'll set out some initial reflections on what that means for decision makers.

NO CHANGE NOVEMBER

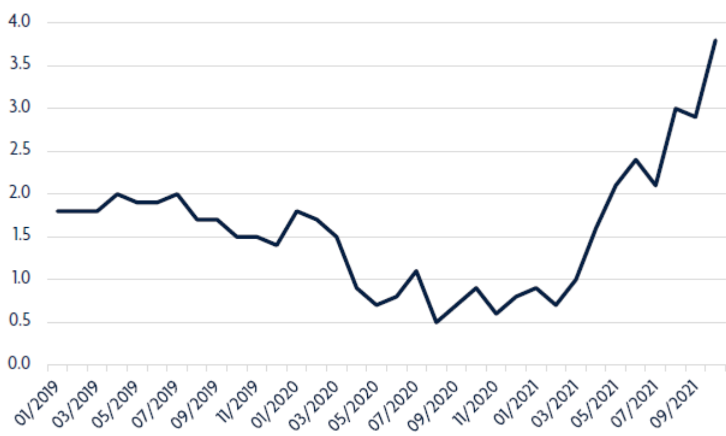
As we noted in last month's Review, November's interest rate decision was likely to be a close call, with markets, on balance, expecting a rise. The MPC, however, voted to retain Bank Rate at 0.1 per cent with only two members preferring a 15-basis point increase.

The Committee's decision came alongside its updated forecasts in the November Monetary Policy Report. Key changes to the outlook in November's forecasts were on inflation. The Bank expects CPI inflation to rise to 4.5 per cent in November and remain around that level through the winter, accounted for by further increases in core goods and food price inflation. CPI inflation is now expected to peak at around five per cent in April 2022, materially higher than expected in the August Report. However, it still expects these upward pressures to dissipate over time – a consequence of supply chain disruptions easing, global demand rebalancing and energy price rises coming to a halt.

Growth since the August forecast had also been slightly slower than expected, in the UK and the global economy. Supply chain disruptions were, again, at play here as well as slightly slower than forecast consumption growth at home.

The key uncertainty for the committee was post-furlough labour market developments. The expectation is that unemployment is likely to tick higher in Q4, and that wage growth will moderate from current levels next year.

Chart 1: CPIH inflation, annual percentage change



The messaging on a future rate rise was, nevertheless, consistent with that in recent meetings. Modest tightening of monetary policy over the forecast period was likely to be necessary to meet the two per cent inflation target sustainably in the medium term. And the Committee judged that its latest forecasts reinforced that view, but the timing will depend on more information on the labour market and the extent to which inflationary pressures are likely to persist.

In the December meeting, the Committee is almost certain to add the new Omicron variant of concern to that list of uncertainties – more on that in a bit....

LABOUR MARKET SINCE THE END OF FURLOUGH

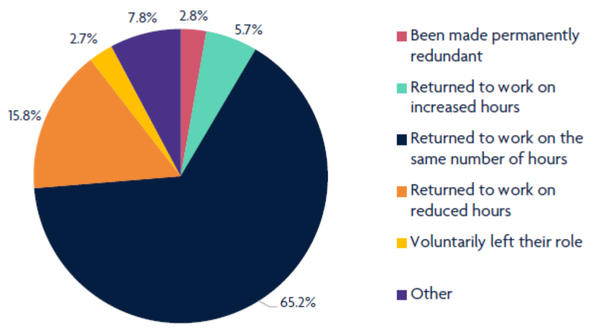
Turning first to developments in the labour market since the Committee met in November. The headline labour market indicators from ONS run to September, when the furlough scheme was still in effect. That said, it was a solid month for employment growth. The employment rate rose 0.4 percentage points to 75.4 per cent, driven by record high inflows from unemployment into work. The unemployment rate fell back to 4.3 per cent – the lowest since 2020 Q2.

Vacancies also continued their march higher, to hit another record high in the three months to October, with all sectors reporting vacancy levels higher than that seen prior to the pandemic.

So far so good. Separate data also showed, however, that at the end of the CJRS there were over one million people fully or partially furloughed. The drop off in numbers had been slower than the MPC had anticipated. Nevertheless, some survey evidence from the ONS BICS suggests there isn't too much to worry about. Of those surveyed businesses that still had employees furloughed in September, around two-thirds had returned to normal working hours with their employer, with around three per cent made permanently redundant (Chart 2).

This would seem fair justification for the further downward revisions from forecasters to the unemployment rate for this year and the next. Currently, the unemployment rate is predicted to end this year at 4.8 per cent and 4.3 per cent at the end of the next, down from forecasts of 5.7 per cent and 4.9 per cent respectively in June.

Chart 2: Destination of post-furlough employees, percentage



Source: ONS BICS

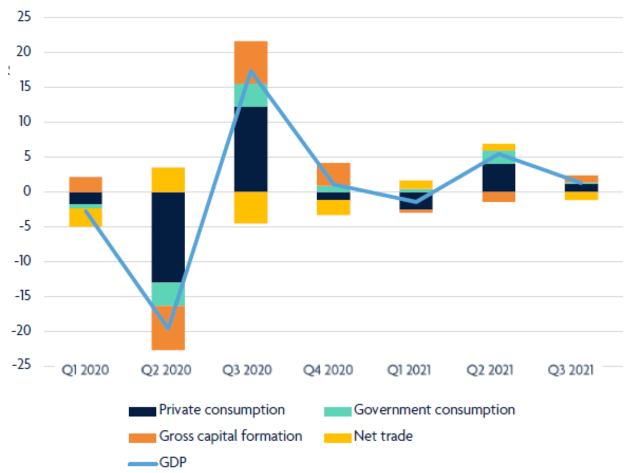
Q3 GROWTH

The economy chugged along in the third quarter, with GDP expanding by a decent 1.3 per cent, down from the 5.5 per cent recorded in Q2, when activity was boosted by a significant lifting of Covid-19 restrictions. Positive contributions came from a range of fronts, but most significantly from continued growth in household consumption, which rose by two per cent on the quarter (Chart 3).

ONS notes that a good proportion of this increased spending was on services, notably hotels, restaurants and travel. And looking at the industry sector composition of growth, there were big gains in accommodation and food services and arts and entertainment. Retail sales were somewhat softer on the quarter as consumers switched back to buying experiences rather than buying stuff.

There were also ongoing positive contributions to the headline GDP number from government spending and fixed investment – mainly from government, but business investment was also up on the quarter, though still some way from pre-pandemic levels.

Chart 3: Contributions to quarterly GDP growth



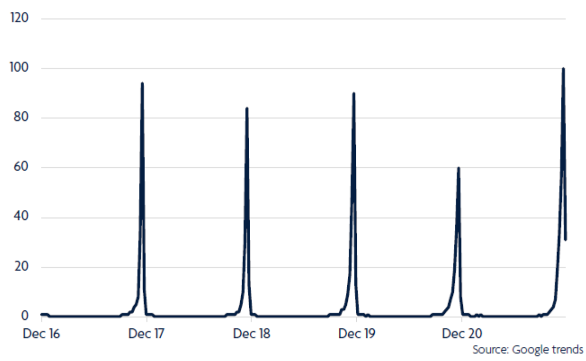
Three notable weak spots in the data for Q3. Manufacturing and construction output both recorded declines in the three months to September – supply chain disruptions were widely cited as factors behind the fall. This is reinforced in recent PMI surveys, which report extended lead times and some weakness in export orders for manufacturers. And the drag from net trade on growth is the third weak spot. Exports, notably of goods, contracted in the quarter while imports, particularly fuels and travel, increased, leading to a widening of the trade deficit.

Q4: ON THE ONE HAND

Another quarter of growth in Q3 still leaves the economy around two per cent smaller than it was before Covid-19. Expectations from the OBR and Bank of England were for a return to pre-pandemic levels at the turn of the year. There are some reasons to be cheerful. While supply chain disruptions and rising input costs are still a significant feature of private sector surveys, there remains some confidence that orders will continue to improve, even if in fits and starts.

While the expectation of forecasters is that these bottlenecks will start to ease, the new Covid-19 variant could throw a spanner in the works. Thus far, governments have introduced some precautionary measures, but it is a race to discover more about Omicron. If we see renewed impacts on travel, this could delay any easing in supply chains disruptions. For example, pre-Covid virtually all air freight coming into Heathrow was in the belly-hold of passenger planes. If the emerging recovery in international travel is halted, this could also impact on the movement of goods.

Chart 4: Black Friday internet searches



While we noted early that retail sales have been more subdued in recent months, the runes from Google trends suggest spending to strengthen over the quarter. Internet searches for 'Black Friday sales' this year rebounded back to levels seen in 2018 and 2019, perhaps indicating that consumers found their shopping mojo in November (Chart 4).

But again, on the other hand, Omicron may have some impact on consumer behaviour in December. While there is limited new government guidance, the potential for individuals to respond to the new variant with voluntary social distancing could put something of a brake on consumer activity in the typically high-spending Christmas period.

RATE RISE IMPACT... WHEN IT COMES

So, to returning to where we started... what does this mean for interest rates? The emergence of the new Covid-19 variant and the associated uncertainty surely lengthens the odds of a December increase. Nevertheless, whenever it comes, this is a quick crib sheet of who might be impacted.

- Not too many mortgage holders. 74 per cent of mortgage borrowers are on a fixed rate contract, with 96 per cent of borrowers opting for this option since 2019.
- In 2021, around 45 per cent of borrowers opted for a five-year fixed mortgage.
- Approximately 850,000 mortgage borrowers use a tracker rate currently and 1.1 million mortgage borrowers are on a standard variable rate (SVR).
- More business lending has also moved to fixed rates, in large part a consequence of the uptake of government-backed loans through the pandemic. Around half of outstanding loan balance are on fixed rates.

ROUND UP

What a difference a month makes. The road back to pre-pandemic levels of activity has hit a bump with the new Covid-19 variant. The extent to which this will delay or derail recovery is yet to be seen. But the uncertainty this will bring presents renewed downside risks to growth going into 2022 – both at home and in the global economy.

While the government has adopted a relatively light touch response initially to the new Covid-19 strain, the wait for more information may, even temporarily, weigh on both business and consumer sentiment. And if the Omicron variant is more aggressive and spreads rapidly, supply chain disruptions could be exacerbated, putting further upward pressure on inflation. These are two scenarios a recent forecast update from the OCED has pointed to.

Policy makers will likely revert to a wait and see stance. Key to mitigating the risks is the continued push on vaccinations – booster jabs in the UK and ensuring access to vaccines in parts of the world where vaccination rates remain low.

Indicator	Period	Value	Change	2021 Forecast*
GDP	Q3 2021	1.3%	↓	7.0%
CPIH inflation	Oct 2021	3.8%	↑	4.0%
Unemployment rate	Sep 2021	4.3%	↓	4.8%
Average earnings	Sep 2021	5.8%	↓	5.4%
Brent crude	Nov 2021	$81.33	↑	-
$ Exchange rate	Nov 2021	$1.34	↓	-
PSNB	Oct 2021	£18.8 bn	↑	£181.6 bn

Source: ONS, HM Treasury, Bank of England,