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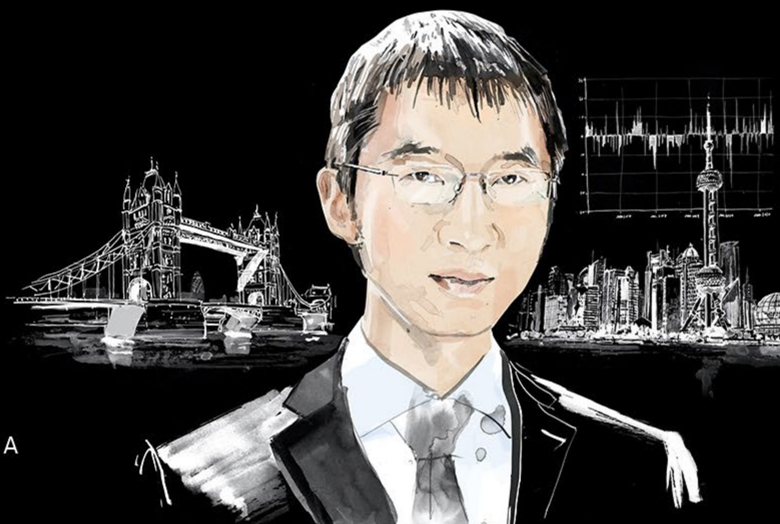


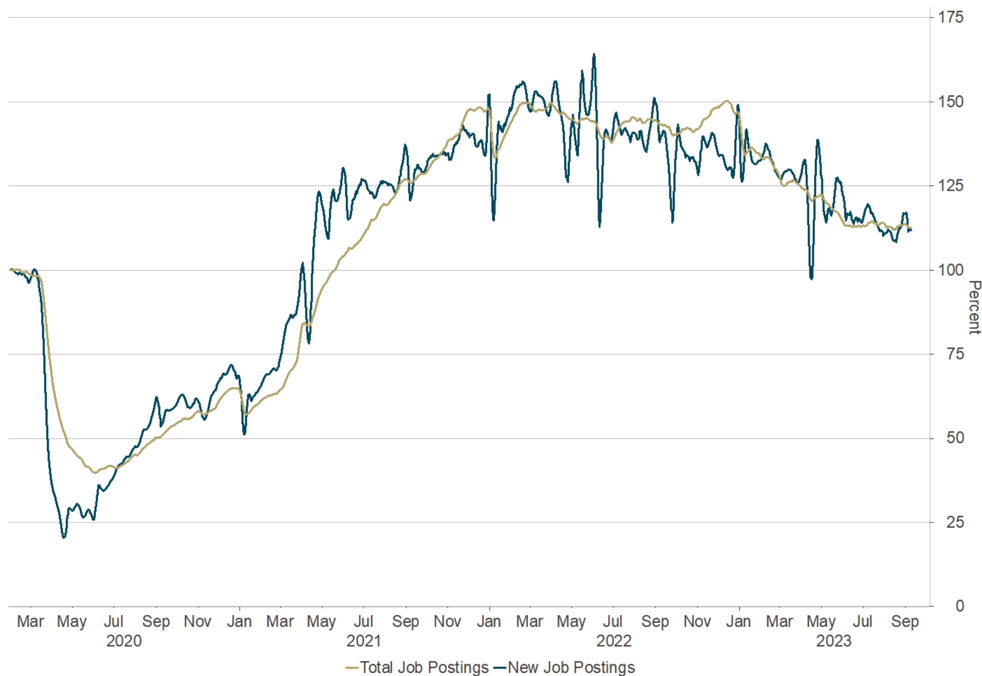
September 20, 2023

Labour Market Preventing BoE Pause

We expect the Bank of England on Thursday to somewhat emulate the ECB and hike the Bank Rate one last time, by 25bp to 5.50%. Almost by definition at this stage in the cycle, the move will likely be construed as a ‘dovish hike’ and this would be reinforced by the soft CPI print for August which was just released. If the post-ECB performance of the euro is anything to go by, sterling is unlikely to find much support ex-post. Perhaps surprisingly given a negative outlook on growth and concerns about inflation, we believe downside risk to GBP and UK assets in general will not be as big as for Eurozone equivalents. The market largely put the UK in a ‘secular stagflation’ camp ever since the mini-budget crisis last year. Now, however, the Eurozone risks moving into that camp, even if only on a cyclical basis, and this could lead some material realignments in asset allocation.

We think the main near-term risk to the BoE’s outlook still comes from labour markets, as wage risks remain in place. The latest high-frequency data suggests that while labour market openings continue to fall, the pace has slowed slightly in recent weeks; this could be seasonal in nature. In Europe, as we highlighted last week by comparing high-frequency job openings in Germany and France, it is the manufacturing-exposed economies which are under greater stress. In August, the BoE MPC statement acknowledged that the direction of travel for labour markets was finally correct, as there were “some indications that it is loosening…although it remained tight in absolute terms”.

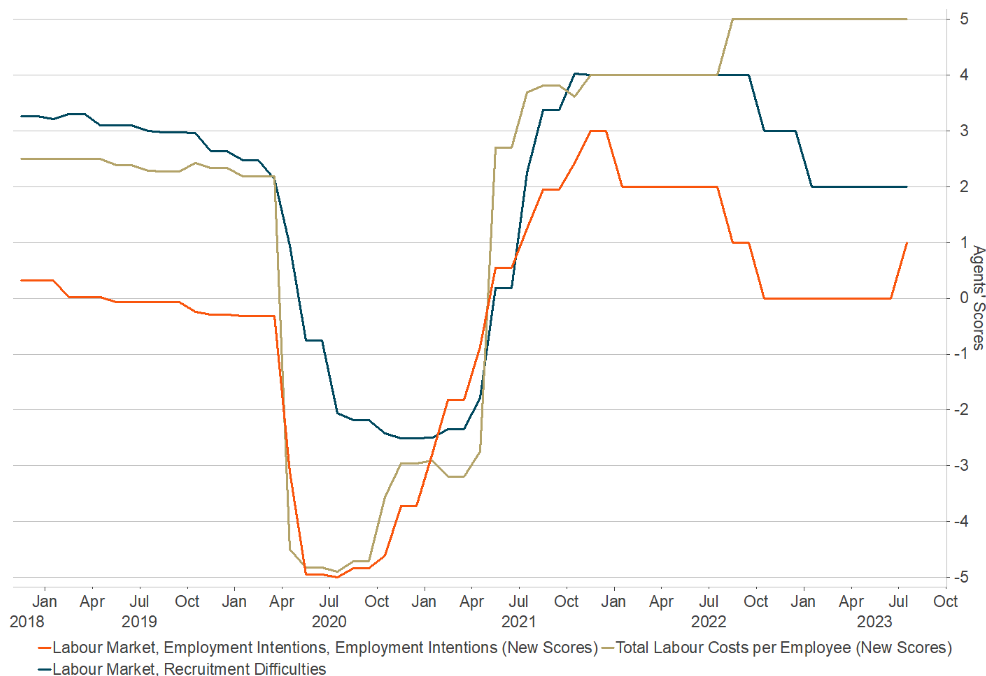
UK Job Openings, High-Frequency Data



Source: Macrobond, BNY Mellon

Based on the latest BoE Agents surveys, we can see (below) that even the “loosening” is marginal at best. The latest available data shows all three employment categories (employment intentions, labour costs and recruitment difficulties) moving back positive due to the recovery in employment intentions. Recruitment difficulties have not had any corresponding pickup, but the forward-looking indices do not point to any strong deceleration in the labour market. That naturally translates into ongoing cost pressures, which the agents’ survey shows remaining at cycle highs. The BoE will likely look for some seasonal relief after summer, and recent activity data suggests the critical services sector had been contracting through the summer months. So deceleration may yet materialise, but data confirmation is needed before a majority on the MPC can feel comfortable to start holding rates.

Labour Components, BoE Agents' Reports



Source: Macrobond, BNY Mellon

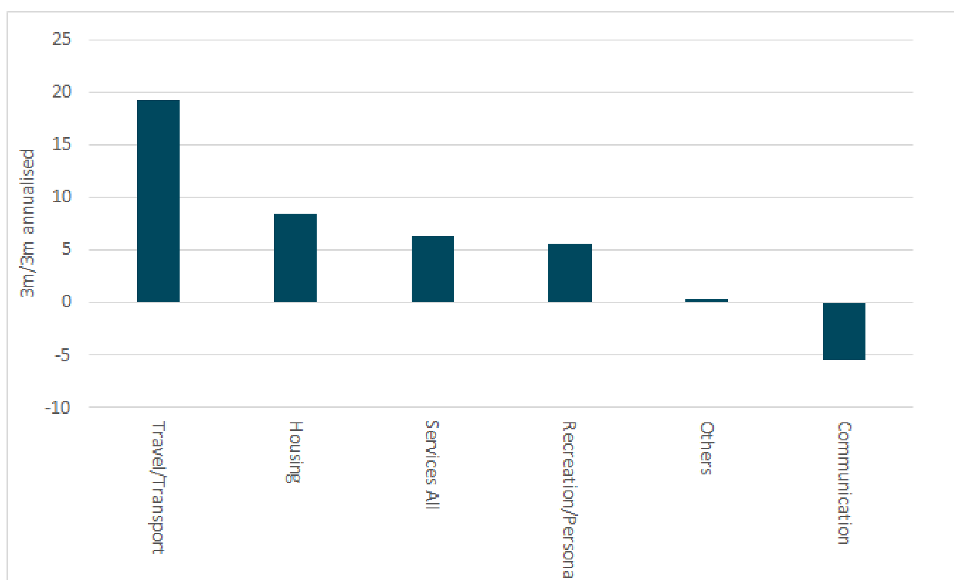
As is the case with all G10 central banks at present, the rebound in commodity prices will require additional vigilance – higher input costs coupled with tight labour markets is the fastest channel for a renewed wage-price spiral. Considering that the BoE had identified inflation persistence as 'crystallised', to continue with this analogy, the current priority is to prevent the crystal from hardening. That means further tightening is necessary. Even though we do not expect the Fed to move this week, the ECB's hike and the dollar's resilience also point to some degree of pass-through risk, which, coupled with higher energy prices, could further destabilise inflation expectations.

The risks are particularly acute in travel and transport, which as shown below remain by far the strongest contributor to UK services inflation per the latest data. This is also where exposures to energy prices can be large relative to other sectors. Furthermore, there does not appear to be much contraction in prices in any of the main services-based components apart from communication. On the contrary, the annualised rate of the most recent sequential prints continues to point to high single-digit price growth as of August. Upon decomposition, we suspect that labour will remain the biggest contributor to current price increases. The lack of 'deceleration' means the MPC will likely repeat its assertion from August that services inflation is "projected to remain elevated at close to its current rate in the near term".

The bottom line on prices in the UK is that there are no material marginal downside drivers amongst the price components showing the largest persistence, and no indication of

broader labour market loosening in any of the key leading indicators. Despite the soft headline CPI for August, the more services-exposed RPI numbers are still quite robust. Accordingly, the same price arguments made in the previous meeting continue to stand. This means there is very little justification for the BoE to hold rates, especially considering the new risks emanating from energy prices. More reassuringly, these risks are currently isolated to gasoline and should not result in any changes to the energy price cap, which would be far more consequential for household inflation expectations, as witnessed in 2022.

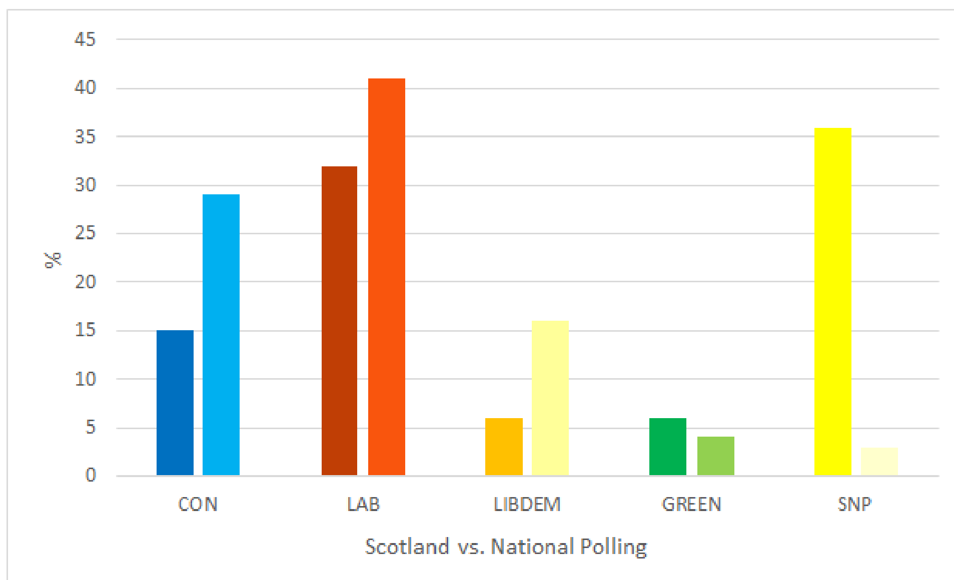
Services CPI, Sequential Annualised



Source: Macrobond, BNY Mellon

We also highlight that the political calendar is relatively crowded through next meeting cycle: three by-elections will be held, two of which are Conservative Party seats being vacated. Those two will likely be considered further tests of the current government's popularity and the opposition's ability to gain further ground in England. However, we agree with political analysts that the third by-election, to be held in the Scottish constituency of Rutherglen and Hamilton West and being vacated by a former member of parliament for the Scottish National Party (SNP), is far more consequential for overall electoral dynamics. In contrast to English seats, this by-election will be the first test of the Labour Party's recovery in Scotland. The Party was traditionally the largest in Scotland, but the 2014 Independence Referendum led to a comprehensive realignment in Scottish politics: Labour's seat count fell from 41 in the 2010 general election to just one in 2015 – the same as their present representation.

Opinion Polls, UK-wide vs. Scotland



Source: Redfield & Wilton, YouGov/TheTimes, BNY Mellon

As shown above, the SNP continues to dominate voting intentions in Scotland relative to the rest of England. Even though consensus remains for Labour to obtain an outright majority in the next general election based on current polling, this is largely on account of weak support for the Conservatives. Paths to a parliamentary majority would likely widen materially should Labour make strong inroads into the SNP's share in Scotland.

For the Conservative Party, the worst-case scenario would be heavier-than-expected losses in the pair of English seats and a very strong Labour showing in Scotland. This outcome would likely be consequential for the economy because it could increase the chances of "budget giveaways" in the November Statement, which could be the last budget ahead of general elections expected in May 2024. Widespread fiscal injections in Europe amid the cost-of-living crisis that we have been concerned about have not come to fruition. However, with electoral challenges for incumbents only accumulating in Europe, fiscal activism may yet rear its head and contribute to inflation persistence.

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