Market Insights Quarterly

LLOYDS BANK

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Summary

- Robust GDP growth in first half of year to moderate as interest sensitive spending slows down in second half of the year
- Headline inflation to rise later this year, while core inflation edges lower
- BoE to reduce Bank Rate gradually, starting in Q3 and eventually reaching 3.5%. Quantum of active QT is expected to be reduced

Conditioning assumptions

- Wars in Ukraine and Middle East do not extend beyond current borders
- Post-election fiscal policy to be less restrictive than Spring Budget 2024 plans, while still meeting the current fiscal rules
- Continuity of existing US policies is assumed regardless of who wins the Presidential election

Group Economics

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UK Macro, annual average	2023	2024	2025	2026
GDP growth	0.1	0.8	1.2	1.6
Latest consensus[1]		*0.5*	*1.1*	*1.7*
Unemployment rate	4.0	4.5	4.8	4.8
CPI inflation	7.4	2.5	2.5	2.1

UK Macro, end year[2]	2023	2024	2025	2026
GDP growth	-0.2	1.5	1.4	1.6
Unemployment rate	3.8	4.7	4.8	4.8
Latest consensus[1]		*4.4*	*4.4*	*4.3*
CPI inflation	4.2	2.5	2.4	2.1
Latest consensus[1]		*2.2*	*2.2*	*2.1*
House prices	1.8	1.2	1.4	1.0

Global Macro, annual average	2023	2024	2025	2026
GDP growth	3.3	2.9	2.5	2.5
CPI inflation	7.5	7.3	5.0	4.0

UK Interest Rates, end year	2023	2024	2025	2026
Bank Rate	5.25	4.75	4.00	3.50
2y yields	4.32	4.04	3.81	3.68
10y yields	3.78	4.06	3.99	3.83

Exchange Rates, end year	2023	2024	2025	2026
GBP USD	1.27	1.28	1.29	1.29
GBP EUR	1.15	1.18	1.16	1.14

Global Interest Rates, end year	2023	2024	2025	2026
Fed Funds Upper Bound	5.50	5.00	4.50	4.00
US 10y yield	3.88	4.20	4.16	4.17

Source: LBG, position as of 30/06/2024 and disclosed in LBG's Q2 2024 financial reporting.

1 Consensus as of HMT's 'Forecasts of the UK economy', May and July 2024.

2 Q4/Q4 for GDP, CPI and house prices; Q4 for unemployment rate.

Known unknowns

- Lack of clarity on state of UK labour market, pending results from 'Transformed' Labour Force Survey
- Impact on private investment of greater public investment (crowding in versus crowding out)
- Extent of downturn in China's housing market and consequences for global inflation

Context

This forecast was finalised at the end of June. As this was before the General Election, we assumed a more supportive fiscal policy than had been announced in the Spring Budget, whichever party won the election. In particular, we assumed that current spending would rise in line with nominal GDP and an additional £5bn of capital spending.

The global backdrop is challenging. Economic and political relations between the US and Europe versus China and Russia continue to deteriorate. These divisions are already reflected in lower trade and investment flows between blocs which make up almost 60% of world output (PPP basis).[1] Next year the average G7 fiscal deficit and net debt burden are expected to be 5% and 95% respectively (IMF data). We assume that global GDP growth will slow over the next two years (see table).

UK Outlook

We interpret the quarterly evolution of the economy as a 'cycle within a cycle' against some deeper labour supply issues. Business cycles are lengthy and gradual economic expansions punctured by the occasional fall in output. Changes in financial conditions can generate mini-cycles – or cycles within business cycles.

In the second half of last year falling inflation enabled market interest rates to fall by 150ps at the same time as real incomes began to rise. Interest rate sensitive components of demand – housing, consumer durables and some parts of investment – strengthened. This led to robust GDP growth of 0.7% in the first quarter followed by further growth in May.

Expectations of an aggressive easing of monetary policy proved to be misplaced. Market interest rates have since returned to more moderate levels, leading to slightly higher borrowing costs and lower mortgage applications. This is the start of the chain of interest sensitive spending which we expect to lead to more moderate GDP growth in the second half of the year.

Of more concern is the tepid growth of the labour force. The UK is the only G7 country with an activity rate (employed and unemployed as a share of population) below its pre-Covid level. Two thirds of this fall in activity is due to rising long term sickness. As well as the social and fiscal costs, this limits the rate at which the economy can grow without causing higher domestic inflation, in the absence of a marked improvement in productivity growth.

Unemployment is expected to reach 4.9%, although there is a high degree of uncertainty around the Labour Force Survey. We expect the current high levels of services and wage inflation to moderate in the coming quarters. But lower domestic inflation will be offset by higher energy prices and slower goods deflation.

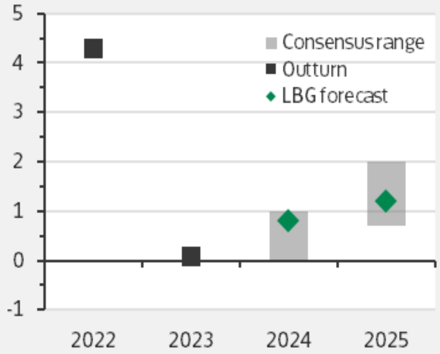
Monetary policy

With inflation close to target, we expect that the Bank of England will reduce Bank Rate in the third quarter this year. Thereafter, we expect further rate cuts will be gradual with the terminal Bank Rate at 3.5%, reached around mid-2026. A higher 'neutral' interest rate relative to the pre-Covid period bears out the sectoral shifts required to meet the security and climate challenges.

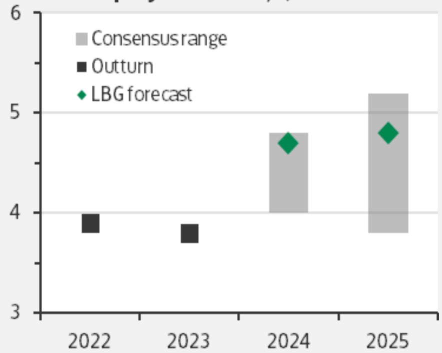
In September the Bank is expected to announce updated plans to reduce the stock of assets held in the Asset Protection Facility (APF). Last year the Bank announced a target reduction of £100bn divided between maturing bonds and sales of bonds or 'active QT'. Approximately £80bn of APF bonds mature next year suggesting a lower quantum of 'active QT' to avoid difficulties in liquidity management.

Forecast comparison

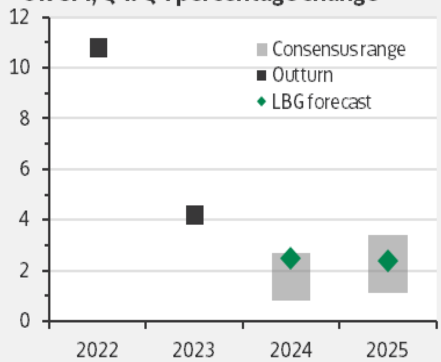
UK GDP annual percentage change



UK unemployment rate, Q4



UK CPI, Q4/Q4 percentage change



[1] Gopinath, Gourinchas, Presbitero and Topalova (2024) Changing Global Linkages: A New Cold War?, IMF WP24/76

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