Appendix A

Link Treasury Services Limited - Detailed economic commentary on developments during quarter ended 30th June 2021

During the quarter ended 30th June 2021 *(quarter 1 of financial year 2021/22):*

- GDP rose by 2.3% m/m in April as restrictions were lifted on non-essential retailers;
- There were signs that activity was given another boost in May as indoor hospitality resumed;
- Sharply increasing virus cases in June delayed the final easing of lockdown restrictions by four weeks;
- Inflation accelerated to 2.1% in May due to energy effects and a surge in reopening inflation;
- Gilt yields and sterling made little headway, while the FTSE 100 failed to catch up on the S&P 500.

The economic recovery stepped up a gear as non-essential retailers and outdoor hospitality reopened on 12th April. The 2.3% m/m gain in GDP in April was the fastest pace of growth since July 2020 and left the economy just 3.8% below its February 2020 level. It was the accommodation and food sector and the retail sector that led the charge with monthly gains of 44.1% and 8.9% respectively.

Activity was given another boost in May as indoor hospitality reopened on 17th May. Households were keen to return to restaurants. The seven-day average of restaurant diners shot up from around 35% below the same period in 2019 to around 30% above it after 17th May. And there were further signs that the recovery shifted up a gear as the IHS Markit/CIPS composite PMI surged to an all-time high of 62.9 in May. Admittedly, there has since been a recent softening in some activity indicators. Retail sales volumes fell by 1.4% m/m in May and the Bank of England CHAPS data showed a dip in the value of consumer spending on electronic cards from 1.3% below the February 2020 value in May to 5.2% below it in the first two weeks of June. What is more, the composite PMI also declined from 62.9 in May to 61.7 in June. But we think that this is a sign that the economic recovery is evolving as consumers substitute spending on goods towards services, rather than a sign that the recovery is spluttering. Indeed, our CE BICS indicator, which has been a reliable barometer since the onset of the pandemic, suggests that growth has been strong in May and June. As a result, we think that GDP rose by around 1.5-2.0% m/m in both May and June.

The final stage of lifting lockdown restrictions on social distancing and large events was delayed in June. This was triggered by a sharp rise in new virus infections. These have increased from a low of around 1,600 per day in early May to over 20,000 by the end of June. Fortunately, this rise has not translated into a sharp increase in hospitalisations. Another reason for the delay was to buy some time to further the vaccine rollout. Currently, nearly half of the total population has received a second vaccine dose and over two thirds have received their first dose. At its current pace, the government is more or less on track to hit its target of vaccinating all adults with a first dose (roughly 53 million) by the end of July.

While Prime Minister Boris Johnson has said that the final domestic restrictions are likely to end on 19th July, this four-week delay is unlikely to prevent the economy from climbing back to its pre-pandemic size by the autumn. This is because the biggest bump to activity came from reopening hospitality in April and May and a delay of four weeks means that the final boost to activity will come only a month later. So, we think that monthly GDP will rise back to the pre-pandemic peak of February 2020 in August, rather than July as we had previously thought.

Meanwhile, households showed that they are willing and able to drive the recovery. Consumer credit increased in May for the first time since August 2020. And the rise in the amount of cash in households' bank accounts of £7.0bn in May was above the 2019 average rise of £4.7bn, suggesting that households are still amassing excess savings. That means there is the potential for faster rises in GDP further ahead should households choose to spend those excess savings.

Some sectors will take longer to recover than consumer spending. Trade flows are still well below pre-crisis levels and trade with the EU remains especially depressed after Brexit. Exports values to the EU, excluding erratics, were 5.7% below their December level in April, while imports were a whopping 19.1% below. The slower recovery in the euro-zone and lingering Brexit effects are still hampering the recovery in trade with the EU, which will probably continue to lag behind the broader recovery.

After being subdued over much of the pandemic, inflation picked up sharply in this quarter. A large portion of the rise in CPI inflation from 0.7% in March to 1.5% in April was due to temporary energy price effects. Fuel price inflation added 0.3 percentage points (ppts). And the 9.2% increase in Ofgem's gas and electricity price cap from 1st April added 0.3ppts too. Inflation climbed further in May to 2.1% and core CPI inflation rose from 1.3% to 2.0%. Some of this was driven by reopening inflation, with clothing inflation, restaurants/hotels inflation and package holidays inflation all rising and likely rise further. Meanwhile, cost pressures are building earlier in the price pipeline. The input prices and output prices balances of the IHS Markit/CIPS manufacturing PMI both reached record highs in June. Core input producer price inflation picked up from 7.4% in April to 7.8% in May and core output producer price inflation rose from 2.5% to 2.7%.

A strong recovery is underway in the labour market. The 113,000 rise in LFS employment in the three months to April was the largest rise since February 2020 and the ILO unemployment rate edged down to 4.7% from 4.8%. The strong set of labour market figures for April fed concerns over the anecdotal reports of labour shortages and its possible impact on inflation from higher wage growth. Vacancies rose to just 3.4% below their pre-virus level in May and online Adzuna vacancies suggest that the official measure of vacancies rose to 20% above pre-pandemic levels in June.

The myriad of factors boosting inflation (energy price effects, utility price effects, supply/shipping constraints, commodity prices and reopening), are likely to prove temporary. As such, the Bank of England will probably look through increases in inflation above the 2.0% target due to these factors. Indeed, the minutes of the June meeting emphasised "the medium-term prospects for inflation" and left intact the forward guidance designed to stress the MPC's patience.

So, we still think financial markets are wrong to price in an interest rate rise from next year. **Instead, we think it will not be until late 2023 that inflation breaches 2.0% sustainably, with the Bank tightening policy from 2024. And when the Bank does tighten policy, we think it will unwind QE, (shrink its holdings of gilts), first rather than raise interest rates.** The Bank is likely to proceed very cautiously by simply not reinvesting the proceeds from maturing gilts. The maturity profile of the Bank's assets points to around £45bn of QE being unwound per year. And we suspect the MPC would want to wait to see how unwinding QE is influencing the economy and financial markets before raising Bank Rate. So, the first rate hike may not come until a year later, perhaps in 2025.

In the wake of the hawkish surprise at the Fed's May meeting, the gilt yield curve flattened in the UK, but not to the same extent as in the US treasury market. That said, most of these moves have since unwound. **Our forecasts that the Bank will tighten policy later than the markets expect, and unwind QE before raising interest rates, will probably lead to a steeper gilt yield curve, driven by rising long yields.**

The FTSE 100 rose by 5% over Q2 but failed to make up any lost ground on the S&P 500 or Dax 30. However, the easing in COVID-19 restrictions in the UK helped the more domestically orientated FTSE 250 to outperform the FTSE 100. And we think that the favourable valuation and composition of UK equities should help them outperform their global peers over the rest of 2021. We expect the FTSE 100 to rise from 7,100 now to 7,500 by the end of 2021 and to 8,250 by the end of 2022.

In the US, CPI inflation accelerated from 4.2% in April to 5.0% in May, including a jump in core CPI inflation from 3.0% to 3.8%. That was mostly driven by categories directly affected by loosening virus restrictions. But there are also signs of pressures in other sectors too. <u>That means not all the upward pressure may prove transitory as the Fed expects.</u> The Fed revised up its median projections for interest rates to include two 25bp hikes in 2023. We think the upward pressure on inflation will be greater and longer lasting in the US than in the UK. **That is why we think the Fed will tighten (in 2023) before the BoE (in 2024), so the risks to our forecast for the pound to stay close to $1.40 for the next couple of years are to the downside.**

The more positive economic outlook this year for the UK compared to the **euro-zone** means there is scope for the pound to rise against the euro from €1.16 now, perhaps to €1.22. But as the economic recovery catches up in the euro-zone, sterling might fall back to €1.17 by the end of 2023. In the euro-zone, the vaccine rollout has picked up considerable speed. The euro-zone is now on track to vaccinate 70% of its adult population by July. And economies have gradually reopened as virus cases have fallen significantly. This progress means that we now think GDP increased by 1.0% q/q in Q2. After HICP inflation rose to 2.0% in May, we think that reopening inflation may push headline inflation above 2.5% in the second half of the year. But as inflation will drop back in 2022, the ECB will persist with its ultra-loose monetary policy.