

FOCAL POINT

Core inflation persistence to trigger ECB/BoE tighter for longer

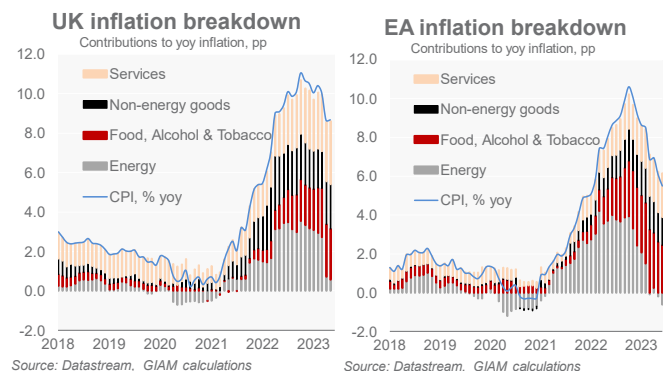
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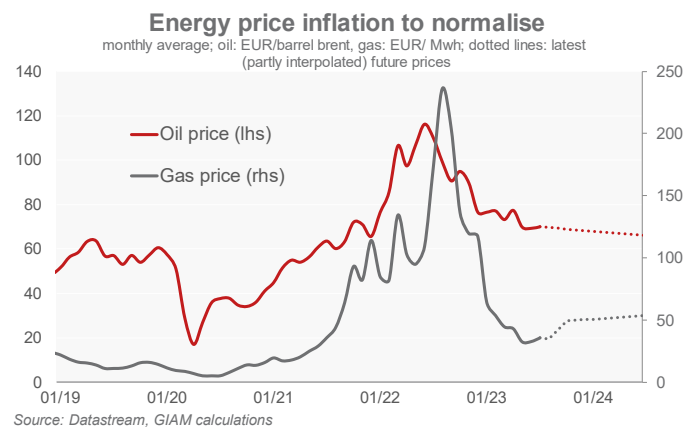
- The recent bold hike by the BoE (50 bps) and hawkish comments from the ECB at the Sintra meeting have fostered market suspicion that another round of inflation-induced monetary tightening might be in the offing.
- While energy and food prices will increasingly provide relief and the influence of “greedflation” is expected to abate, wage growth will remain elevated due to tight labour markets. This will keep underlying inflation stubbornly high.
- Accordingly, core inflation is likely to “overshoot” the ECB’s and BoE’s targets. Thus, given hawkish Sintra comments, we now expect the ECB to hike to 4%; the BoE to raise to 5.75%. Both central banks will keep their peak rates well into H2 2024.
- Notwithstanding the expected key rate hikes, a sustainable rise in Gilt and Bund yields is not on the cards. On a hedged basis, a historically high yield gap makes very long-dated Gilts attractive for euro investors.

Last autumn the inflation tsunami peaked in the major Western economies. But since then, the development became somewhat more heterogeneous. The UK has been exposed to the highest rate among its Western peers after May headline inflation remained stuck at 8.7% yoy while core rates even accelerated to 7.1% yoy. By contrast, in the euro area (EA), annual inflation came down to 6.1% yoy in May, falling further to (a flash reading of) 5.5% yoy in June. The US registered a significant fall to only 4% yoy. The stubborn UK inflation prompted the Bank of England (BoE) to raise Bank Rate by 50 bps, citing marked deviations from its May inflation report expectations. Hawkish remarks were also issued by e.g. the [Fed](#), the [ECB](#), and the [BIS](#). ECB President Lagarde outlined a lengthy fight against high inflation “*come what may*” in her [Sintra speech](#). **Markets were somewhat spooked by fears that another round of monetary tightening might be in the offing.** In this paper we scrutinise inflation drivers to

gauge their likely near-term developments, shedding light upon the differences and similarities between the EA and the UK. We then discuss what might be implied for the two central banks and government bond markets.



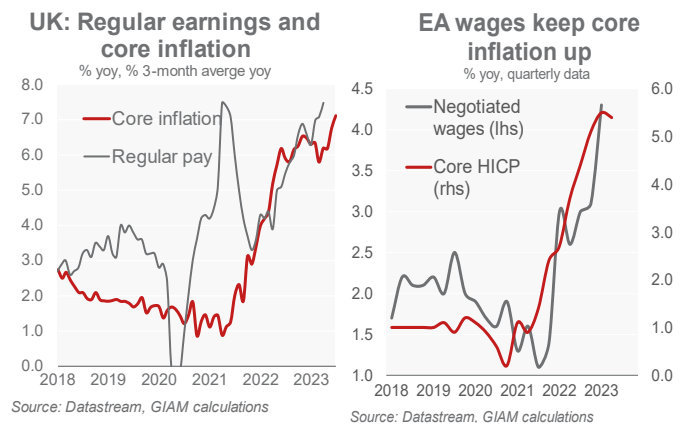
Energy disinflation to start later in the UK: The inflation spike was triggered by soaring energy and food prices as post-pandemic price increases were amplified by the effects of the Ukraine war. However, underlying oil/gas commodity prices peaked broadly around mid-2022, implying subsequently negative base effects. But while in the EA, the energy subcomponent already fell into deflationary territory (-5.6% yoy in June), it was still much higher in the UK with 8.4% yoy in May. The key reason is that the **UK regulator's price mechanism (Ofgem)** implies that the **recent drop in wholesale gas prices lower utility bills only with a delay**. However, ultimately, the energy component in the UK will as well contribute negatively to headline inflation. Food inflation is another field of difference. In the UK, food inflation has been still as high as 18.1% yoy in May, compared to the EA with about 12.5% yoy (May). Weather effects in supply countries played a role, but also more complicated customs procedures following Brexit. Food prices are expected to slow as summer seasonal crops will increase supply. But UK food inflation is likely to remain higher than in the EA due to post-Brexit effects.



Core inflation: Underlying inflation (headline inflation ex food, energy, alcohol & tobacco) is also significantly higher in the UK. While core inflation has slightly receded in the EA to 5.3% yoy in May but edged up to (a flash reading of) 5.4% yoy in June, it leaped up to 7.1% yoy in the UK and has already been re-uptrending since February. Following, we discuss wages and elements of “greedflation” as influence factors.

UK labour market even tighter: A key driver of core inflation is wage growth which is set to stay elevated due to tight labour markets. Labour hoarding in times of demographically induced shrinking labour supply will keep employment up even in times of weaker activity. In the **UK**, specific effects will lend stronger support to wage growth than in the EA. First, the rise in **pandemic-related labour shortage** (post-Covid cases) has been amplified by a slow (NHS) health system, forcing a rise in the inactivity rate. **Post-Brexit new immigration rules** also curb labour supply, leading to

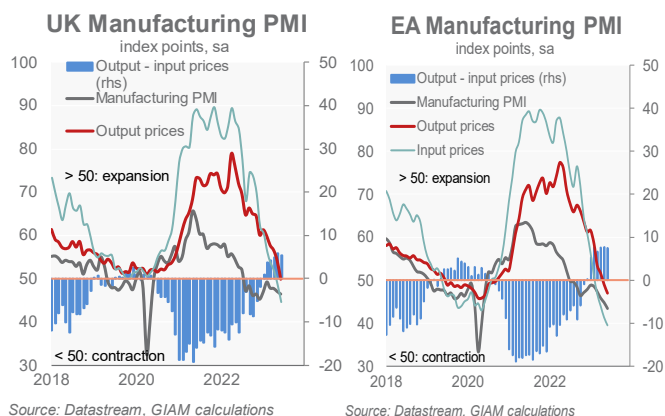
bottlenecks in some sectors. Hence, we expect the UK labour market tightness to ease only very reluctantly, keeping wage growth relatively high and widespread across sectors. Latest data show an average (of the 3-month average) weekly wage growth of 7.6% yoy in the private sector (similar in both manufacturing and services) while less in the public sector (5.6% yoy). This is significantly higher than in the EA where compensation per employee grew by only 5.2% qoq in the first quarter of the year. That said, in both regions we expect wage growth to maintain momentum above historical norms.



Stronger UK pipeline pressure: In the UK, the recent acceleration in core inflation was not only due to service prices (7.4% yoy) but also non-energy goods prices (6.8% yoy). However, in the EA only services inflation advanced (to 5.4% yoy in June) while goods price inflation eased from its February peak (of 6.8% yoy) to 5.5% yoy in June. We attribute the divergent goods inflation pattern to stronger pipeline pressure in the UK. Some greedflation (or profit margin-induced inflation) also plays a role. It can be proxied by the difference between output prices (prices charged) and input prices within the PMI survey. Manufacturing PMIs signal a deepening recession in both regions. Accordingly, PMI price subcomponents have slumped into contractionary territory, but input prices have receded more strongly. Consequently, the “greedflation” proxy turned positive towards the start of the year in both regions. But the PMIs also suggest that EA firms are more advanced than UK ones. **Producer price indices (PPI) suggest that there is more pipeline pressure in the UK.** May data show that UK PPI output goods inflation has fallen to 2.9% yoy, while in the EA, it fell already to -1.6% yoy. That said, the manufacturing PMI price components suggest that pipeline pressures in the sector will continue to soften in both regions and we expect the sector's recession also to restrict firms' ability to widen/keep margins.

Still potential for services greedflation: A common feature of the EA and the UK was the strong divergence between recessionary manufacturing alongside healthy (although weakening) service sectors. The UK and EA service output price PMIs are still in markedly expansionary territory and

decelerating only at a slow pace. The output-input price difference remained negative, but this has historically always been the case. The latest value of -7.2 (UK) and -5.2 (EA) are above the long-term average of -8.5/-6.2 (UK/EA). Thus, the message is twofold: **Service prices will contribute significantly to sticky CPI inflation** which might also give more room for “greedflation” to increasingly shift towards services.



Receding headline but sticky core inflation: In sum, looking through short-term gyrations (UK inflation may even edge up a bit near-term) headline inflation will significantly fall under the influence of base effects from energy prices and softening food inflation. We expect it to recede by year-end to somewhat below 3% yoy in the EA but only 4.9% yoy in the UK. However, core inflation is expected to remain sticky given high nominal wage growth and signs of additional “greedflation”. Given the UK labour market to ease only reluctantly, stickiness in **core inflation will remain more persistent in the UK than in the EA**. We look by year-end for readings of around 4% yoy in the EA and 5.5% yoy in the UK. The higher inflation pressure is mirrored by an annual expected inflation rate of UK inflation at 7.9% (UK) vs. 5.5% in the EA this year, receding to 2.9%/ 2.5% (UK/EA) in 2024 and slowing to slightly above the BoE’s and ECB’s 2% target in 2025.

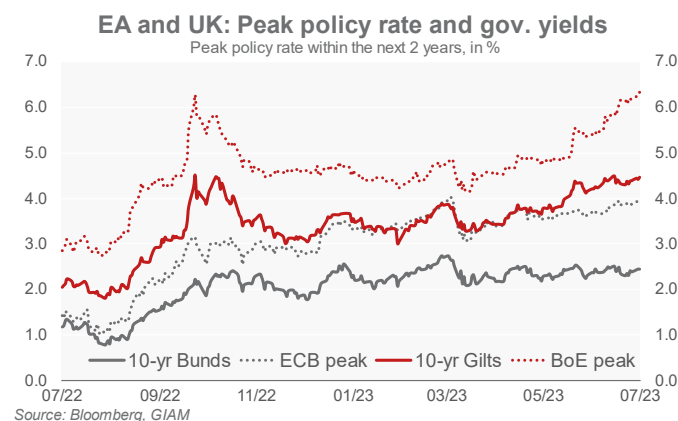
BoE and ECB to maintain peak rates for longer: The extraordinarily tight labour market development, greedflation, and the related risk of second-round effects have prompted a recent series of hawkish central bank comments. Moreover, in the UK, the expected inflation path will likely prove markedly higher than the BoE’s expectations (May inflation report). Back then, the BoE saw 2023-25 inflation at 7.6%, 2.5%, and 0.8%. We expect the BoE to account for the worsened inflation outlook and to hike further, with a 50 bps hike in August and a 25 bps increase in September now in our books. We see core inflation to materially slow towards BoE target in Q3 2024 which will then provide room to **first cut Bank Rate to 5.25 by the end 2024 and 4% by the end of 2025**. For the ECB we consider the hawkish Sintra speech

by President Lagarde where she emphasized the risk of second-round effects and the de-anchoring of inflation expectations making clear that this will be a multi-year challenge. Albeit we continue to think that the ECB’s macro scenario of a return to potential growth from H2/23 onwards is way too optimistic, we acknowledge the latest hawkish wording and now expect a **ECB peak (deposit) rate of 4.0%** (from 3.75%) reached in September (from July). However, the key upshot from Lagarde’s Sintra speech is that the peak rate **will likely be maintained for longer than previously thought**. We now no longer look for a first rate cut by mid-2024 but later into 2024.

Gilts to outperform Bunds in a friendly environment

The hawkish central banks faced with high inflation rates have left their mark on bond markets. Meanwhile, UK government bond yields have more than made up for the decline in yields triggered by the banking crisis in March (Bund yields are still below March levels despite the recent rise).

However, given the weak growth environment, (slowly) declining inflation and the already priced further key rate hikes, **a further sustained yield increase seems unlikely**. This is all the more true as past (and future) key rate hikes will tighten financial conditions and the current yield level attracts investors that worry less about the perfect timing.



While the decline in Bund yields is likely to be moderate, the downside potential for UK yields appears higher. Several factors suggest this: Our short- and medium-term ECB key rate forecast is broadly in line with market pricing. On the contrary, amid a less benign macroeconomic outlook than consensus, we expect only 75 bps until the BoE will reach its peak in September. Financial market participants currently expect the peak to be reached only after additional 150 bps in Q1 2024. This implies some downside potential for short-dated UK yields.

However, the impact of additional key rate hikes on longer-dated bonds should not be overstated anyway. Unexpected **further key rate hikes** may support the short end of the curve

but are less likely to affect long-term yields as the boom-and-bust scenario would become more likely. Financial markets are increasingly taking the risk of overtightening into account. At 130 bps in the UK, the gap between the forecast key rate peak and the level expected in 2 years is even higher than in the EA (100 bps). In fact, the 10-year UK yield fell (and the spread to Bunds narrowed) on the back of the recent surprising 50 bps hike by the BoE.

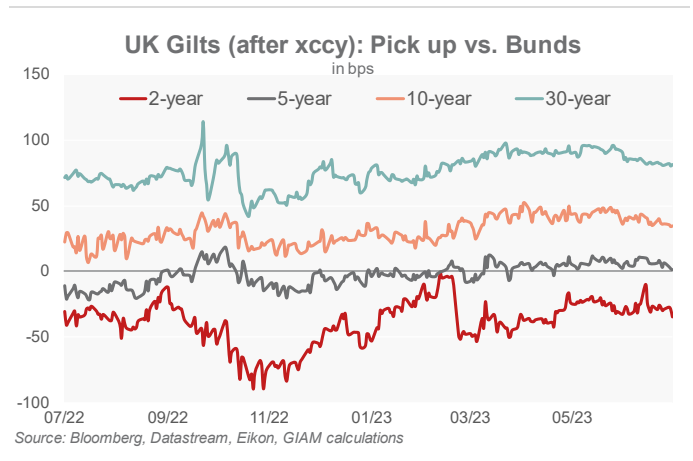
That the BoE has more easing potential longer term than the ECB is also evident from the fact that the **2-year UK real yield has risen to almost 1.4%, while it is only 0.7% in the EA**. Even with longer maturities, the real yield gap in favour of the UK does not appear to be sustainable (10-year: 0.8% vs. 0.2%).

The current high level is also illustrated by the fact that the 10-yr UK yield is currently around 85 bps above the key rate level expected in the medium term (approx. by 5y3m OIS). On the contrary, 10-year Bund yields are trading at around the key rate level expected in a few years. Finally, the unfavourable inflationary environment in the UK appears to be adequately priced by markets. Even long-term UK inflation expectations are well above those in the EA (10-yr: 3.9% vs. 2.5%).

To sum up, although the key rate cycle in the UK may end later than in the EA implying higher uncertainty (being an upside risk for UK yields), we consider Gilts to be more attractive than Bunds given the historically high yield gap of more than 200 bps across the curve.

30 bps, and for 30-year bonds Gilts even yield 80 bps more than corresponding Bunds in case the bonds are held to maturity.

If the trade is unwound before maturity the performance depends on the fx and bond price development up to this point. However, the very long end offers some protection against near-term data uncertainty, the already very high spread level leaves little leeway for further widening, and the mark-to-market uncertainty looks limited as UK and EA inflation and growth are seen to converge long term. Accordingly, we recommend investors with longer trade horizons to set up 30-year spread tighteners to benefit from the expected narrowing of the yield gap.



However, one caveat applies. We expect the British Pound to depreciate going forward. This implies losses for UK Gilt long positions. Accordingly, **we suggest hedging the position**. The most straightforward way to do this is to do complete hedging over the lifetime of the bond to exclude the foreign exchange (fx) risk. The chart above shows that in this case for short- and medium-dated bonds the carry will be eaten up and a complete hedge makes little sense. However, long- and very long-dated Gilts continue to offer a significantly higher yield than Bunds. For 10-year bonds, Gilts offer a pick-up of

Imprint

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