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UK: STRENGTHENING LABOUR MARKET SIGNALS RATE HIKE SOON

Berenberg Macro Flash

June	Unemployment rate	Average earnings, ex bonus 3m/yoy
Actual	**4.4**	**2.1**
Previous	4.5	2.0
Consensus	4.5	2.0
Berenberg	4.5	2.1

Focus on what really matters for monetary policy

For the UK monetary policy outlook, today's upside surprise for labour demand and acceleration in wage growth matters far more than yesterday's downside surprise for headline inflation (2.6% in July vs. est. 2.7%). Unemployment fell to 4.4% in June (4.5% exp.) while weekly earnings ex. bonus accelerated to 2.1%, for the third month in a row, in line with our expectations but above the consensus (2.0%). Because monetary policy works with a lag, interest rate setters at the Bank of England (BoE) focus more on what the inflation picture will look like in a year or two.

The UK's current period of above-target (2% target) inflation is mostly driven by the fall in sterling since the Brexit vote, which has pushed up import prices. But this effect will fade as the annual change in import prices washes out of the consumer price index. As the BoE is already looking through the sterling-effect, whether or not current inflation is a little higher or lower than expected is largely irrelevant for the policy outlook. However, in the BoE's model, an acceleration in wage growth today will cause underlying inflation to rise in the future. Today's upside surprise thus raises the chances of a policy tightening soon.

Keep in mind the BoE's forecast and guidance

At 4.4%, unemployment is at its lowest rate since 1975 and below what the BoE considers the equilibrium rate (4.5%). The post-Lehman labour market recovery has been driven by strong employment gains. At 75.1%, the 16-64 year old employment rate is currently at a record high. Meanwhile, the number of vacancies – labour demand - is at a near-record high. Coupled with continued resilient growth at home and strong growth abroad, solid labour demand alongside limited supply suggests that wage growth can continue to accelerate towards 3% - in line with the BoE's forecast – over the next year.

In his key message to markets at the August Inflation Report, governor Carney explicitly pointed out that the Monetary Policy Committee (MPC) expects to raise rates more often than the market was pricing in: 'if the economy were to follow a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by the yield curve underlying the August projections'. The BoE believes that inflation would overshoot its 2% inflation target for the next four years if it were to raise rates only twice until the end of 2020 as markets were pricing in when the BoE prepared its August report.

We thus continue to expect a first hike of 25bps in November and four hikes in total between now and the end of 2019. Of course, we see a clear risk that the BoE may wait with the first hike until Q1 2018. But overall we think that our call is broadly consistent with the bank's guidance. That the BoE is being unusually explicit in trying to talk the yield curve up suggests that it could be on the cusp of hiking and would like to avoid a potentially disorderly adjustment in markets and in the real economy. Please see, 'Is the market misreading the BoE?' for more detail.

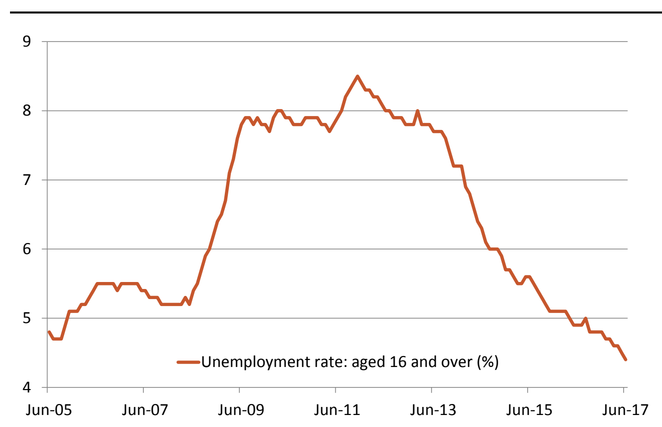
Finally, some good news for households

After a tough year, there is finally light at the end of the tunnel. Households could already be past the worst of the real wage squeeze. Inflation might tick up a little more in the coming months before gradually trending towards its medium-term underlying rate (c2.3%). But a likely continued acceleration in nominal wage growth means that real wage growth will likely return within just a few months. Because household fundamentals have strengthened during the post-Lehman expansion, real consumption has continued to expand over the past few months as real wages have declined modestly. Households are temporarily using their balance sheets to smooth consumption as higher import prices push inflation up and squeeze their real incomes. Continued solid labour demand can underpin a recovery in household confidence which should further improve next year as real wage growth returns. This outlook underpins our call for continued real household consumption growth and continued modest economic growth (1.7% in 2017, 1.6% in 2018 and 1.7% in 2019).

The critical point: While the resilience of the economy to the near-term demand side shock from Brexit is positive, the long-term potential damage coming from a slower rate of trend growth after the UK leaves the EU remains a major problem for UK households. In our base case, Brexit will reduce trend growth to 1.8% from 2.2% before Brexit. In terms of income growth for households, the 0.4pt difference in headline growth will add up badly over time.

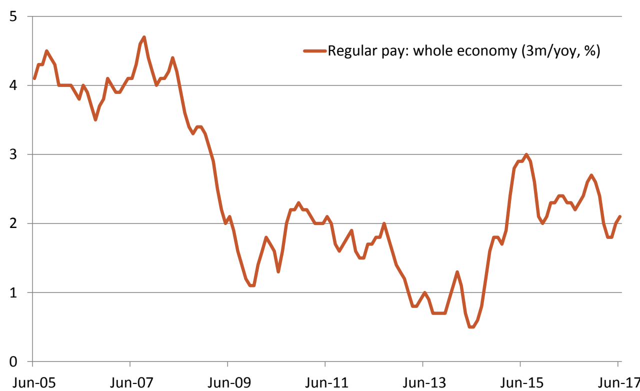
%	JUN	MAY	APR	MAR	FEB	JAN
Unemployment rate	4.4	4.5	4.6	4.6	4.7	4.7
Average earnings, ex bonus 3m/yoy	2.1	2.0	1.8	1.8	2.0	2.4

Chart 1: Unemployment rate



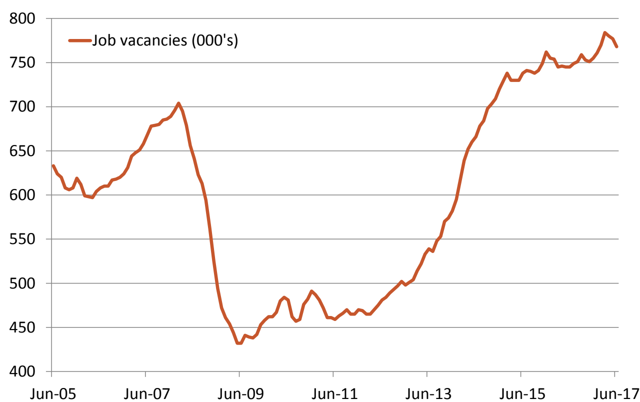
Source: Office for National Statistics, Haver Analytics

Chart 2: Regular pay: whole economy



Source: Office for National Statistics, Haver Analytics

Chart 3: Job vacancies excluding agriculture, forestry and fishing



Source: Office for National Statistics, Haver Analytics

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