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UK: WAGE PICK-UP AMID BREXIT UNCERTAINTY PUTS BOE IN A TRICKY SPOT

Berenberg Macro Flash

Nov	Unemployment rate %	Av. earnings, ex bonus 3m/yoy	Av. earnings, 3m/yoy
Actual	**4.0**	**3.3**	**3.4**
Previous	4.1	3.3	3.3
Consensus	4.1	3.3	3.3
Berenberg	4.1	3.3	3.3

The UK labour market is showing real signs of tightness: record labour demand, low unemployment and accelerating wage growth. If the UK avoids a hard Brexit, expect the BoE to step on the brakes more forcefully over the medium-term.

Key takeaways from the November labour market report:
(1) The UK added 141k jobs on a 3m/3m basis – the highest in seven months - as employment rose to a record high of 32.5 million. The unemployment rate declined from 4.1% to 4.0% (Chart 1);
(2) the number of job vacancies (the key measure of labour demand) was 853k – the highest on record (Chart 2);
(3) wage growth excluding bonuses remained stable at 3.3% 3m/3m yoy, while wage growth including bonuses edged up 0.1ppts to 3.4% (highest since July 2008) (Chart 3).

Next hike should come in February, but the BoE will probably wait until May
Ideally, the BoE should hike rates as soon as possible to lower elevated inflation expectations and to make a credible commitment to its 2% inflation target. Inflation expectations advanced over the course of 2018 to a post-Lehman high. However, cautious of adding to the downside risks by hiking rates too quickly, the BoE has trodden carefully since the Brexit vote, increasing rates only twice. Continuing this trend, if UK parliament takes it to the eleventh hour – late-March – to agree a solution that avoids a hard Brexit, the BoE may not be prepared to hike rates again until the May Inflation Report. If parliament decides to go for a second referendum, the next hike could be set back even further. This potentially implies – at least - another five months of rising wage growth before the BoE takes another step towards policy normalisation.

In our view, given the growing inflation risks in the labour market, the BoE should hike again as soon as the next Inflation Report in February, or at the very least, make a strong commitment in February to step up the pace of rate hikes if the UK avoids a hard Brexit. This would encourage market rates to edge up. As it stands, we see no strong signal from the MPC that the next hike will come as soon as next month.

Playing a risky game
If the UK indeed avoids a hard Brexit, it is likely that BoE is already behind the curve. The next rate hike (likely in May) will probably take the Bank Rate to just 1.0% - by which point annual wage growth could have risen to well above 3.5% yoy. By comparison, the Fed has lifted its benchmark rate to 2.25-2.5% already, while US headline wages are growing by 3.3% yoy - slightly slower than in the UK. Relative to the UK's potential growth rate - c1.8% in a soft-Brexit scenario – the on-going acceleration in wages may mean that the BoE is forced to scrap its current guidance of gradual and limited rate hikes over the medium-term.

We look for the BoE to step up the pace in 2019 and 2020. We expect two hikes in 2019, with the first one in May, followed by at least one additional hike – likely in August. If wage growth continues to surprise to the upside, the BoE may need to hike three times this year. However, continued elevated global risks and wobbly financial markets may temper any eagerness at the BoE to normalise monetary policy at a quicker pace than that. We project two further hikes for 2020 to take the Bank Rate to 1.75% by Q4 2020.

Chart 1

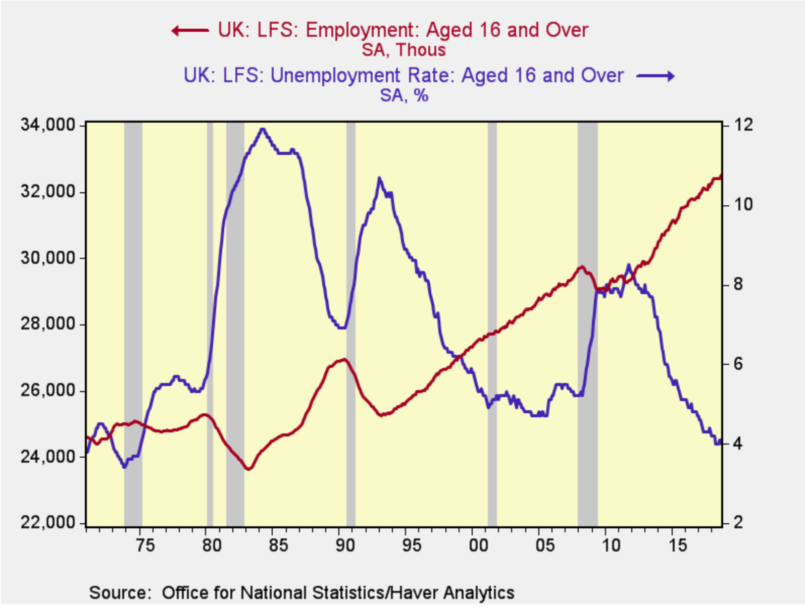


Chart 2

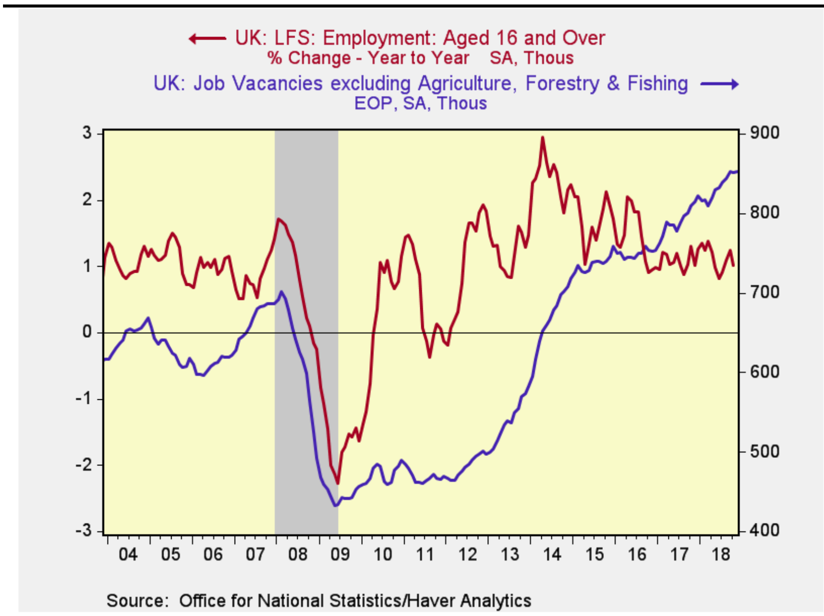
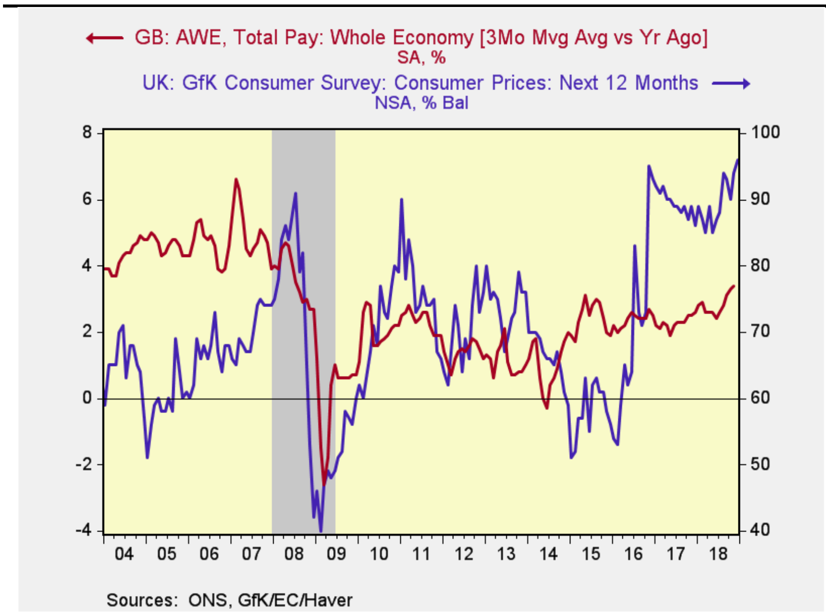


Chart 3



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