Cribstone
Strategic Macro

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BoE Chief Economist Huw Pill's comment that it wouldn't be unreasonable for rate cuts mid-2024 was as reckless as it was truthful. With so much collateral mortgage damage from rate hikes, the BoE needs to avoid using more firepower. However — as George Soros knew in 1992, and Liz Truss painfully learned last year — when you have a vulnerable currency, and you're an island economy that imports inflation, your central bank doesn't get to have the final say.

Unlike the Fed or the ECB, the BoE can't be currency agnostic because the (relatively) tiny UK is a price-taker. Devaluation stokes inflation. If macro funds pile on sterling shorts, it won't be long before we start once again hearing provocative calls for dollar parity. If sterling devalues too much, the BoE has to raise its voice and the cost of everyone's mortgage. It's a lesson our previous PM painfully learned. So long as things seem calm, we can pretend we are in data-dependent mode under BoE leadership. But the reality is very different as virtually all UK mortgages reprice every 2-5 years while German and US mortgage holders see zero change in cashflows from rate changes. Just as tumbling rates during QE proved a windfall to UK mortgage holders, higher rates are a lagged but substantial cash drain.

With the UK already facing stagflation, throw in the possibility that currency weakness alone can force more UK rate hikes, and the conclusion is we're in the nail-biting phase of our quantitative tightening vulnerability. Why would macro traders bother to attack a seemingly undervalued sterling? Because policy makers failed to recognise the stagflation risk inherent in the UK's absurd short duration mortgage market. While two-thirds of homeowners sitting on vast piles of mortgage free housing equity will enjoy higher rates, those are mostly 1 & 2 person older households that are economically less relevant. By contrast, the vast majority of the 7.5mn mortgages — equal to 65% of GDP — are held by working age Brits, or those who rent houses to them. The Resolution Foundation estimates that of the £15.8bn of higher mortgage costs projected from 2021-2026, fully three-fifths had yet to be realized by mid-2023. Almost everyone in the UK who has a mortgage knows their personal inflation could go much, much higher in the coming years, and renters can expect to be passed a portion of this pain. Few other countries have this level of future inflation awareness among the population. That's a wage expectation driver like no other. Throw in interest-only mortgages for well-off Brits tripling in cost, and you've got plenty of richer senior executive types that are suddenly sensitive to the cost of living plight of lowly subordinates. The result? A stagflationary, wage-driven shitshow.

Even high-earning sectors are seeing remarkably generous pay hikes, with Finance and Services up 9.6% June-August and Manufacturing up 8.0%. This isn't a simple tight labour market that can be cooled with rate hikes. Don't tell Turkey's president, but UK rate hikes may actually be raising wage expectations. Hedge funds love a vicious spiral. In 2017, I wrote to Pill and 70 of his BoE colleagues about this looming train wreck. I got a polite reply that implied I had emailed 71 people too many. With a bit more curiosity, they may have been less excited about the UK's hyper-efficient monetary mechanism, and more worried about extending mortgage duration. Oh, and they wouldn't have sent me this letter in 2021 admitting they didn't even have basic mortgage duration data.

How can the UK reduce its vulnerability to a stagflationary attack on sterling? First, everyone on the MPC should do as Governor Bailey did yesterday and hawkishly contradict Pill and anyone else who speculates on when rates might fall. The most dovish thing the BoE can do is to sound more hawkish than the data. Who will attack sterling if they fear the BoE could quickly hike? Second, if wage inflation remains sticky, we need some heroes at His Majesty's Treasury to build policies that specifically target wage inflation without hitting jobs. In a world where orthodoxy insists the only tool is rate hikes that seems anathema, but the UK can't afford more hikes. My two pence: if necessary, tax private sector employers (not employees) on any inflationary wage hikes (say above 4 per cent). It's the equivalent of a higher national insurance rate, but instead of on all workers, just on those whose pay hikes are entrenching inflation. Keep the punchbowl, just dilute the punch.

Finally a call to all heroic Treasury officials. Use the eventual anchoring of inflation expectations to shift us to longer duration mortgage fixes. That's not just to avert a future crisis, there is a big cyclical plus. The long-bond will come in before the BoE starts to cut. If UK mortgage holders can tap this, housing recovers sooner. For any policy maker who figures this out, you'll deserve a stonking (and, in a small way, inflation-stoking) pay rise. Oh, and your boss might actually keep his job.