March GDP data signals that economic activity is losing steam as the cost of living crisis begins to bite. With a bigger squeeze still to come, the spectre of stagflation looms large and unwanted attention is falling on the Bank of England over untamed inflation. Worries are certainly mounting, with China's strict lockdowns weighing on global trade and April's inflation figures – the first to include the 54% energy price cap jump – expected to show another sharp rise.

Worst yet to come. UK GDP contracted by 0.1% in March following a revised flatlining of economic activity in February. Momentum is notably down from a 0.7% increase at the start of the year. The drag came from consumer-facing services, driven by weaker wholesale & retail trade. Output also fell in the production sector, driven by falls in manufacturing and utilities. But all is not lost, yet! Activity in construction reached the highest level since monthly records began in January 2010. Across the first quarter, growth was 0.8% (vs. 1.3% in Q4'21), putting output 0.7% above its pre-pandemic level and meaning UK GDP grew at a faster rate than in other advanced economies. Despite that, falling real income and declining health spending signals a weaker growth path from now on.

How high and how fast? At the last Monetary Policy Committee meeting, three of the members voted for a 50bps hike (double the actual). Michael Saunders is one of them and explained his position in a recent speech. His view is that there are two risks for monetary policy: that excessive tightening would lead to a more significant reduction in activity than necessary; or that insufficient tightening would lead to entrenched high inflation expectations, which would require prolonged period of tighter monetary policy and supressed economic output and employment. Saunders believes that the second risk outweighs the first and faster tightening is advisable now.

Sluggish. The UK trade deficit widened significantly: to £25.2bn in Q1’22, reaching the highest level since records began in 1997. Imports continued a far sharper recovery in March with 9.3% MoM rise, driven by a 9.9% rise in imports from non-EU countries, largely reflecting higher fuel imports. More of this to come as energy price-rises take hold. March saw modest growth in UK exports, which picked up 2.1% MoM in value terms. This rise, however, is due to the ongoing surge in prices. In volume terms exports fell 3.0% MoM and remained 14% below their 2018 levels, while exports from advanced economies in February were 3.5% above. So, the big question is why has recovery in UK exports has been so sluggish?

Worry Beads. Almost 9 in 10 of us now feel the cost of living is rising (can the other one please get in touch?). And with higher essential costs, 41% are buying less food. While months of forced saving during lockdowns allowed some households to fluff up their financial cushion, nearly 1/3rd of us say they couldn’t afford an unexpected £850 expense. It’s nearly 40% for parents (or at least those aged 30-49), with 1/3 borrowing more to make ends meet. No wonder 1/3 of us say we’re highly anxious.

The good, the bad and the ugly. On an upbeat note, high frequency indicators point towards UK consumer spending holding firm as inflation takes a toll on businesses. Debit card purchases increased by 8 ppts in the week ending 5th May, with growth in all spending categories. Eating out also increased by 8%, as covid infection rates fall to lowest since Christmas (in the week ending 7th of May). Meanwhile, although average wholesale gas prices edged down by 14% in the week ending 8th May, prices are 76% higher compared with the same period last year. On an ugly note, soaring costs continue to be the pain point for UK businesses with 26% of them naming inflation as their main concern in May, up from 21% at the end of Feb, with energy prices being the main driver. Let’s see to what extent businesses push climbing costs onto their customers.

Gaining. Unit labour cost (ULC), which measures the relationship between what UK workers are paid and the value of what they produce, grew by 9.6% in fourth quarter vs. 2019. As output effectively stagnated and nominal wages of employees rose, almost all the sectors saw an increase in the ULCs. The only exception was healthcare, where weak wage growth, coupled with elevated activity due to Covid, meant that ULC declined by 5.4%. Even that trend may reverse though as the sector experiences a post-Covid slow-down. The labour share of production income also increased for fifth consecutive year to 60%, highest since 2010.

Unexpected consequences. Some consequences of the pandemic have been pretty predictable, like the increased share of online retailing. But others are much less obvious and new data from the Office of National Statistics has been shedding light on what’s happened with high-contact services. One of the more surprising changes is a greater than 40% rise in turnover for operators of stalls and markets. Stores specialising in food, drink and household equipment have done well (up 6-7%) whereas electronics retailers have seen turnover plummet by nearly a quarter. And there’s further evidence of the staycation boom with short stay accommodation and camping both up by around 70% in Q3 last year.

Whether that trend will survive the reopening of international travel remains to be seen.

Over the hill? In the US, CPI inflation fell to 8.3% in April, from 8.5% in March; the first moderation in eight months. But policymakers at the Federal Reserve remain cautious: the drop was more modest than expected and there are signs that inflationary pressures are becoming increasingly broad based. Core inflation, which strips out volatile items like food and energy prices, rose at an annualised rate of 6.2% in April; twice March's rate. So, while headline inflation will probably moderate further in coming months, don't expect the Fed to let-up on rate hikes anytime soon.