BoE Watch

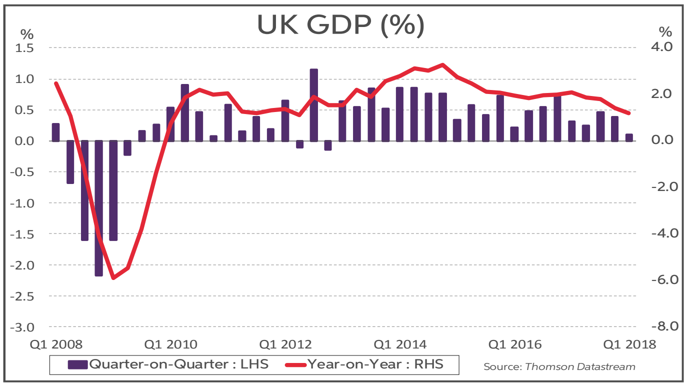
AIB Treasury Economic Research Unit

21st June 2018

August BoE rate hike a distinct possibility

As expected, the June meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The key Bank Rate was left at 0.5%. There was a surprise, though, in the voting breakdown with three MPC members voting for an immediate hike of 25bps. The expectation had been that there would be just two votes (Ian McCafferty and Michael Saunders) as was the case in the previous two meetings. However, they were joined by Andy Haldene, the BoE Chief Economist, resulting in a 6:3 vote for no change to policy.

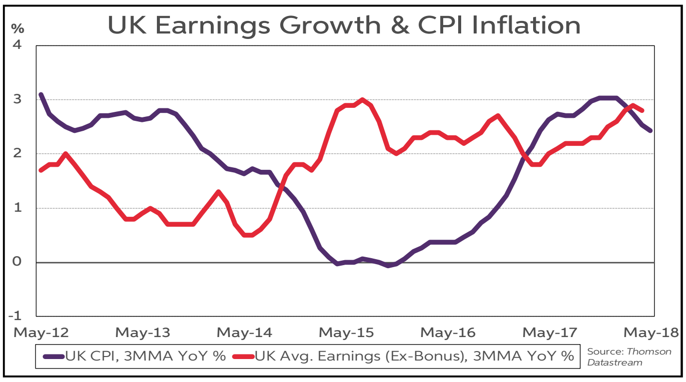
For the majority of MPC members, the data since the May meeting had provided "reassurance that the softness of activity" in Q1 had been largely temporary. However, they deemed there to be value in waiting to see additional incoming macro data, in "order to learn more about the extent" that the economy was evolving in line with its forecasts.



Indeed, the meeting statement and minutes emphasised that a key assumption in the BoE's outlook was that the dip in quarter one would prove temporary and a pick up was expected in the second quarter**.** The MPC commented that this "judgement appears broadly on track". It referenced household indicators of spending and sentiment as well as solid employment growth to support its view.

The most recent set of BoE macro forecasts were contained in the May Quarterly Inflation Report. The MPC downgraded its 2018 GDP forecast to 1.4% (from 1.8%). However, despite the downward revision to this year, the BoE left its growth forecasts for 2019 and 2020 unchanged at 1.7%. Meanwhile, in terms of the inflation outlook, while the BoE expects near term inflation to be somewhat lower than previously forecast, its medium-term view was "only a little lower", reaching the 2% target in two years.

The BoE continues to guide that if the economy evolves as expected, then modest rate hikes over the next 2-3 years would be appropriate. This is predicated on the view that GDP is forecast to grow by "around 1.75% per year on average" over the forecast period. At the same time though, the Bank anticipates that supply growth in the economy will lag behind, averaging around 1.5% over the same period. Therefore, this "excess demand" is likely to result in higher wage growth and domestic cost pressures. Hence, the bias within the BoE to raise rates, albeit on a gradual basis over the next couple of years.



Overall, today's meeting statement and minutes suggest that the hawkish bias within the MPC has increased since the May meeting. The voting breakdown and optimistic views on the economic outlook are evidence of this. Data over the coming months will play a key role in determining the timing of the next rate hike. If the data continue to support its view that the Q1 slowdown was temporary and the economy has recovered momentum in Q2, then a **rate hike at its next meeting in August is very much on the cards.** Futures contracts, though, are not fully pricing in a 25bps increase until the end of the year. Further out, the market is anticipating a 25bps rate hike in 2019 and 2020, taking the bank rate up to 1.25% by end 2020.

In terms of market reaction, sterling made some gains. This was reflected in EUR/GBP edging down to 87.5p and GBP/USD rising above $1.32. Meanwhile, there was a brief rise in short-dated gilt yields.

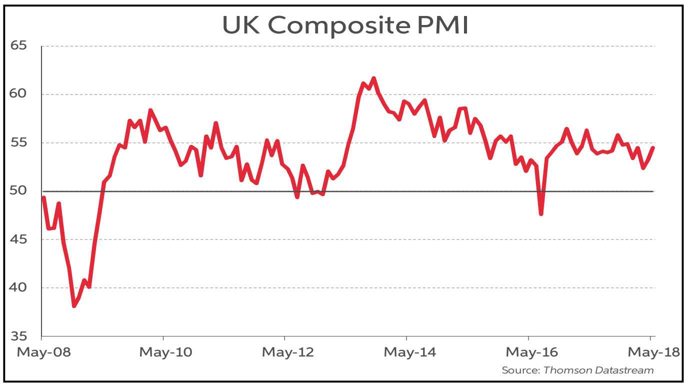
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Mixed UK data in Q2, after weak Q1

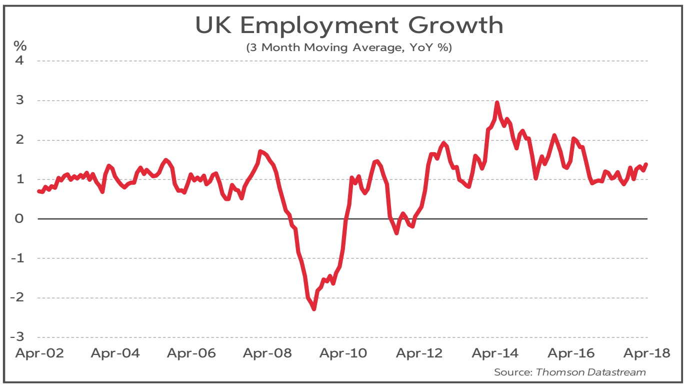
UK GDP rose by just 0.1% in Q1 2018, its weakest quarterly performance since Q4 2012. This followed on from +0.4% in Q4 2017 and +0.5% in Q3. Year-on-year growth slowed for a fourth consecutive quarter to a six-year low of 1.2%. **While severe weather conditions in the first quarter were a factor, the ONS notes that "the effects were generally small".** A fall in inventories, which knocked 0.2 percentage points of quarterly growth, also contributed to the slower pace of expansion in Q1.



In terms of the performance of the economy in Q2, survey data suggest that expansion continues at a modest pace. The Composite PMI averaged 53.9 in April/May, broadly unchanged from Q1's 53.4. This reflects little change in services or manufacturing, while the construction sector looks to have overcome its recent weather related dip. The EC measure of UK Economic Sentiment averaged 106.5 in the first two months of Q2, after Q1's 108.6 performance.

In terms of hard data, the results have been mixed. Retail sales jumped by 1.9% in April/May versus Q1, in which they fell by 0.3%. This reflects a rebound following March's weather related fall, as well as some temporary factors (e.g. warmer weather, royal wedding). Meantime, **industrial production declined by 0.8% in April, with the main manufacturing component recording a sharp 1.2% decline, its largest since October 2012.** This is partly due to a slowdown in demand for UK exports. Goods exports were at a 19-month low in value terms in April, with the UK's goods trade deficit widening to over £14bn, its second largest on record. Meantime, both the Halifax and Nationwide measures indicate that UK house price growth has continued to slow, coming in at around 2% in May, compared to circa 3% in the same month of 2017.

Labour market data have generally been more 'solid' of late. Employment rose by 146k in the three months to April. Year-on-year employment growth has risen to 1.4%, its highest level since Q3 2016. A similar acceleration in labour force growth has meant that the unemployment rate has held at 4.2%, its lowest level since 1975. **Other indicators suggest that labour market 'slack' continues to dissipate, with the BoE's Business Conditions survey showing that recruitment difficulties were near a 13-year high in April.**



The tighter labour market has shown some signs of translating into firmer wage growth. Average weekly earnings rose by 2.8% year-on-year in the three months to April, compared to a rate of 1.8% in the same period in 2017. At the same time, CPI inflation has moved downwards recently, averaging 2.4% in the three months to May. **This indicates that the UK has now returned to a period of real growth in wages.**

Overall, the outlook for the UK economy remains challenging. It continues to be impacted by the uncertainty associated with the UK/EU Brexit negotiations, which is weighing on investment. Only modest growth in real wages is a challenge for the key consumer sector. Although, the BoE looks set to maintain a very accommodative policy stance in the coming years, which should support activity. **The UK Office for Budget Responsibility latest growth forecasts project that GDP will rise by 1.5% this year,** followed by increases of 1.3% in both 2019 and 2020. The BoE is anticipating a slightly better performance, with growth of 1.4% forecast for 2018, followed by 1.7% in both 2019 and 2020.

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com