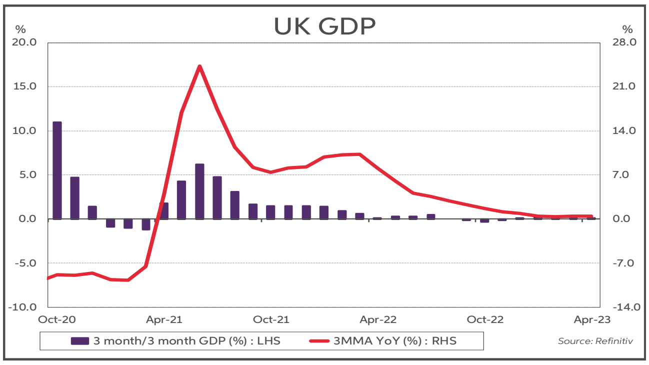
22nd June 2023

BoE hikes by 50bps to 5% and retains bias to do more

The June meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank announce a 50bps rate increase. This followed two 25bps hikes at its March and May meetings. Prior to this, the BoE had implemented 50bps increases in both February and December. In the lead up to today's announcement, there had been growing speculation that the BoE would hike by 50bps, rather than by 25bps as previously anticipated. This was in the aftermath of Wednesday's higher than expected inflation numbers for May. Today's rate hike brings the Bank rate up to 5.00% and marks the thirteenth consecutive meeting where the BoE has raised rates. The Bank has now raised rates by a total of 490bps since it commenced hiking in December of 2021.

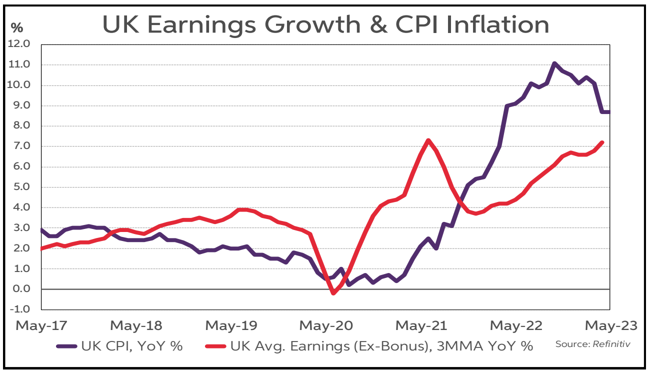
The voting breakdown showed that the MPC continued to be split on its rate decision. Seven of the nine members were in favour of hiking rates by 50bps. In justifying their decision, they noted that second-round impacts in domestic prices and wages arising from external shocks were likely to take longer to unwind than they had done to emerge. They also referenced the "upside news" in recent macro data which indicate more persistence in inflation against the backdrop of a "tight labour market and continued resilience in demand". Meanwhile, two members preferred to keep rates unchanged at 4.50%. They stated that forward looking indicators were pointing to material falls in future wage/price inflation. They also noted that the lagged effects from the previous rate hikes were "still to come through".



The BoE's most recent set of detailed macro forecasts were released at its May meeting, with the publication of its quarterly Monetary Policy Report (MPR). For this year, the BoE upgraded its UK GDP growth forecast to +0.25%, from –0.5% in February. It has also upped its 2024-25 forecasts. For next year, the BoE is expecting growth of 0.75%, compared to the 0.25% fall in GDP projected in February. Further out, the BoE is forecasting growth of 0.75% in 2025, up from 0.25% previously. These represented the biggest upgrades to its growth forecasts since the MPC was established in 1997. Despite the upgrades though, they still represent a subdued outlook with growth running at below 1% in 2023-25, following a twelve month period of economic stagnation.

On the inflation front, the MPR projections indicated that the BoE was expecting inflation to slow to circa 5% by around the end of this year. This compared to 4% in its February Report. Inflation was projected to fall further to 2.3% by end 2024 and 1% by end 2025. Overall, the BoE projects an inflation rate at or just below its 2% target in the medium term. These inflation forecasts were conditioned on the market view at the time that the Bank Rate would peak at around 4.75% in Q4'2023. However, the market is now pricing the peak rate being nearer to 6%. The MPC has emphasised that the risks around its inflation forecasts are skewed significantly to the upside. **Today's meeting statement noted that the current headline, services and core goods inflation rates have all been "much stronger than projected".**

The BoE did not provide any specific guidance on the future course of interest rates. However, it indicated a willingness to hike rates further if required. It stated that it will continue to monitor closely signs of persistent inflation pressures in the economy as a whole. If this analysis shows evidence of more persistent inflationary pressures, then the BoE has guided that a further tightening in monetary policy would be necessary.



In terms of market expectations, there has been a notable firming in market pricing over the last number of week's. This has been in response to inflation printing higher than expected and labour market data showing stronger than anticipated wage growth. Futures contracts indicate that the market expects the Bank Rate to peak at 6% by year end. This view has solidified in the aftermath of today's BoE outcome. At the time of its May meeting, the market was envisaging that Bank Rate would peak in a 4.75-5.0% range by the autumn. Some 50-75bps of easing is anticipated by end 2024, with rates falling back to near 5.25%. **Interestingly, in its communications today, the BoE did not attempt to alter the market's expectation that significant further rate tightening is on the cards.**

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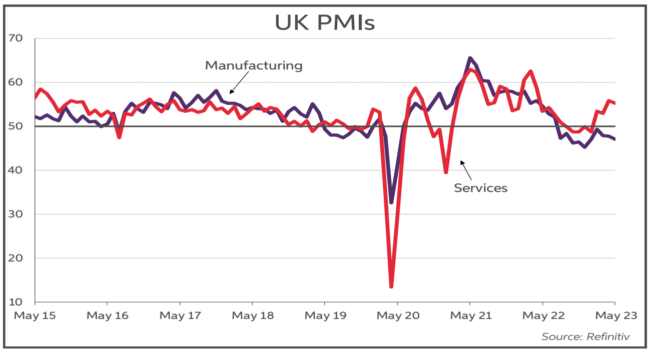
UK economy stagnant, while inflation remains elevated

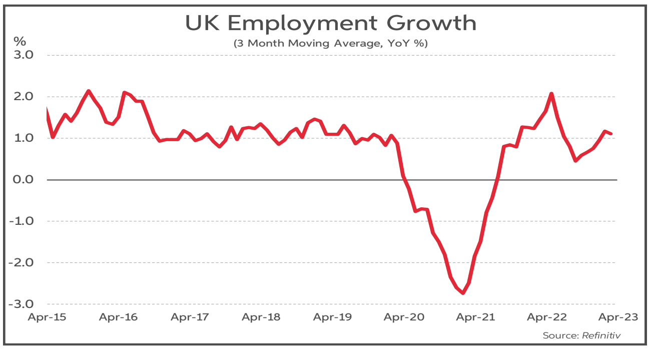


The UK economy narrowly avoided falling into a technical recession over the past number of quarters, exhibiting a flat trend in GDP over the period. GDP rose by just 0.1% in Q4, having contracted by 0.2% in Q3 of last year. The economy than expanded by 0.1% in Q1 of this year. However, growth in Q1 was concentrated at the start of the quarter. Monthly data show output rose by 0.5% in January, before stagnating in February and declining by 0.3% in March. The underling breakdown indicates that consumption rose by just 0.1% in the quarter. Fixed investment rose by 1.3%, while government expenditure fell by 2.5%, partly due to the impact of strikes in the public sector. Elsewhere, exports fell by 8.1%, compared to 7.1% for imports, meaning net trade weighed on growth in the opening three months of the year. Overall, UK GDP was still 0.5% below its pre-COVID level in Q1.

The most recent GDP data suggest growth has remained muted at the start of Q2. The April reading of GDP showed output rebounded by 0.2% in the month, as the sharp 10.1% increase in the value of benefit payments provided a boost to real household disposable incomes. Meantime, retail sales, which have been volatile so far in 2023, rose by 0.5% in April, although, they were still 3% lower in year-on-year terms. Likewise, industrial output was 1.9% lower in April compared to 12 months ago, having declined by 0.3% in the month.

Survey data in Q2 have been mixed, with the services sector continuing to outperform manufacturing. The services PMI has been in expansionary territory for the past four months, rising to 55.9 in April, and printing at 55.2 in May. In contrast, the manufacturing PMI has been in contraction mode for the last ten months, and deteriorated to 47.1 in May. Meanwhile, consumer confidence remain muted, but has improved in seven of the past eight months, since reaching an all-time low of –49 last September.

Labour market conditions continue to be very tight. The unemployment rate edged slightly lower to 3.8% in the three months to April, up from 3.5% last August, but still very low by historical standards. There has been a marked pick-up in employment in recent months, with the number of people employed in the UK now back at pre-pandemic levels. However, tight conditions are placing upward pressure on wages. Average earnings growth accelerated to 7.2% y/y in the three months to April. The BoE Agent's summary of business conditions survey for Q2, released today, shows that companies pay settlements have averaged 6-6.5% so far this year.



Meanwhile, inflation has proven to be much stickier than expected, surprising to the upside in recent months. Headline CPI remained at 8.7% in May, with food inflation in particular at very elevated levels, running at 18.3%. Meantime, core-CPI inflation has accelerated so far in Q2, indicating that underlying price pressures are very strong. Core-CPI rose to 6.8% in April, before climbing to 7.4% in May, with both services and goods inflation moving higher. The BoE noted today, that inflation has printed above its most recent forecasts from the Monetary Policy Report in May, but the MPC reiterated that inflation should decline sharply over the coming quarters and throughout 2024.

Year-to-date, the UK economy has proven to be more resilient than anticipated. However, the economy continues to face a number of headwinds. The OBR estimates real household incomes declined by 3.1% in 2022, and that they will fall by 3.4% this year. A number of MPC officials, including Governor Bailey have stated that inflationary pressures are, "taking a lot longer than we (the BoE) expected," to fall away. If inflation remains stubborn, the BoE will be forced to continue raising rates, which will weigh on economic activity. Thus, the risk of stagflation is still high in the UK. **Overall, growth is expected to remain very subdued over the next couple of years.** Both the OECD and IMF are forecasting GDP growth of circa 0.3% this year, and around 1% in 2024, suggesting the UK economy will avoid recession.

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