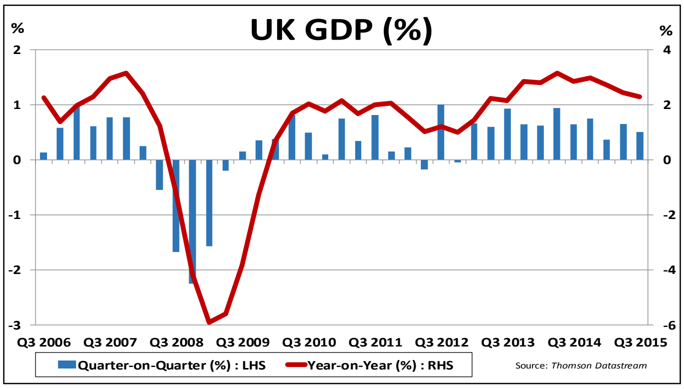
BoE pushes UK rate hikes further out

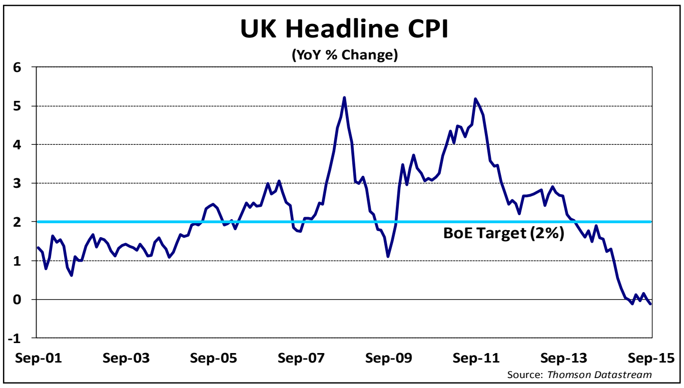
Today's conclusion to the MPC's November meeting was in line with market expectations for no changes to monetary policy. The decision to keep the Bank Rate at 0.5%, where it has been since mid-2009, was not unanimous for a fourth consecutive month. Once again, Ian McCafferty was the sole dissenter, voting for a rate hike. His view was that the "risks that domestic costs would rise more rapidly than in the central projection was sufficient to warrant an immediate increase in the Bank Rate". **For the remaining eight MPC members, they deemed that "indicators of underlying inflationary pressure were not strong enough to justify an increase in Bank Rate".**



However, the November edition of the BoE's 'Super Thursday' did surprise markets with its quite dovish tone. This included the minutes, the November Quarterly Inflation Report, as well as Governor Carney's press conference. The minutes show that the MPC is trying to weigh up the contrasting picture of weaker external demand, mainly due to the slowdown in emerging markets, while at the same time that domestic momentum "remains resilient". Both of these factors have implications for the UK's inflationary outlook and in turn the ability of the Bank to meet its 2% inflation target over the medium term. **Indeed, Governor Carney stated that the BoE's monetary policy must balance "two fundamental forces - domestic strength and foreign weakness".**

These policy deliberations are taking place against a backdrop of very weak inflation, which has fallen back into negative territory, at –0.1%, in its most recent reading (September). The MPC attributes around "four fifths of the deviation" from the target, as being due to "falls in energy, food and other imported goods prices", while the remainder reflects "subdued domestic cost growth". The MPC's assessment is that the global growth outlook has deteriorated since the August QIR and that there "remain downside risks" to this outlook. It also noted that a number of factors are continuing to dampen inflation, including sterling's "past appreciation" and that this is "expected to persist".

As a result, today's Inflation Report includes some downward revisions to its inflation and growth projections. The Bank expects CPI inflation to average just 0.1% this year, down from its previous forecast of 0.3%, 1.1% in 2016 (was 1.5%) and is "likely to remain lower" compared with its August projections "until late 2017". Meanwhile the changes in GDP expectations were more modest, with growth now forecast at 2.7% this year (from 2.8%), 2.5% in 2016 (was 2.6%), and 2.6% in 2017 (from 2.5%).



Overall, after today's dovish updates, the BoE appears to be some way off increasing interest rates and the tightening process is expected to be very gradual. Indeed, based on the Bank's forecasts it could be early 2017 before it starts to increase interest rates. Futures contracts do not envisage a UK rate hike materialising until the end of next year, while for 2017 there are close to two rate hikes being priced in, which would bring the Bank Rate up to just 1.25% by end 2017. The dovish tone of the BoE saw sterling lose ground, government yields fall and futures contracts push back the start date for rate tightening.

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

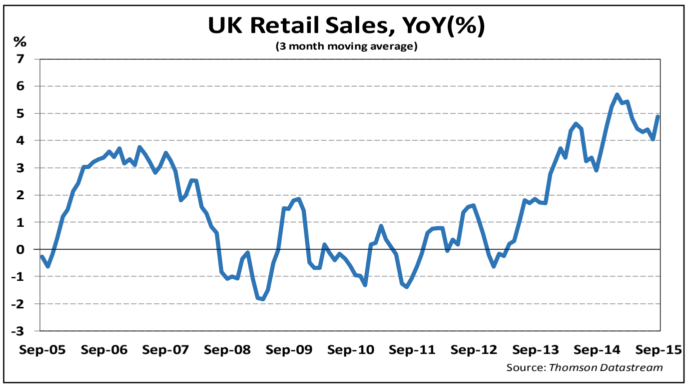
John Fahey
Senior Economist
john.j.fahey@aib.ie

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

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

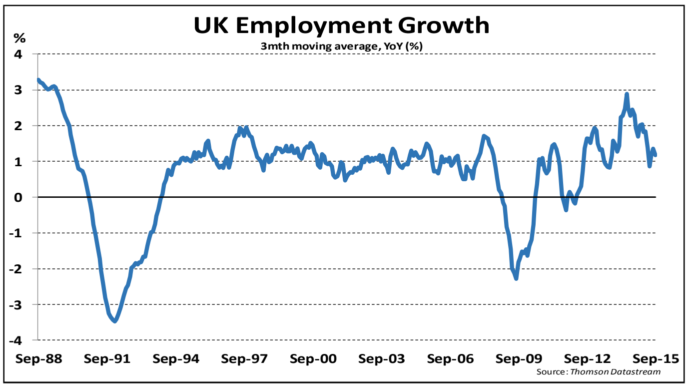
Growth in the UK has slowed

The first reading of UK Q3 GDP showed that the pace of growth slowed slightly from 0.7% in Q2 to 0.5%. In year-on-year terms, growth slowed further, though at 2.3% it remains solid. The breakdown of Q3 GDP showed that **the services sector remained the key source of growth, contributing around 0.6 percentage points** (p.p.), with business & financial services a strong performer in this sector. Industrial production made no contribution to Q3 GDP, with manufacturing contracting again while the very strong pace of growth in oil extraction seen in Q2 was not sustained. Construction was a 0.14 p.p. drag in Q3, with underlying data showing broad based declines in the sector.



While the expenditure breakdown of Q3 GDP will not be available until the second estimate (November 27th), the **retail sales figures for the quarter suggest that consumption remained a key driver of growth.** Retail sales grew by a robust 0.8% for a second consecutive quarter.

The labour market has had something of a mixed performance of late. Employment grew by 140k in the 3 months to August, compared to a decline of 63k seen in Q2. The UK unemployment rate fell to 5.4% in the 3 months to August, its lowest rate since June 2008. Although, the claimant count rose in both August and September, suggesting the unemployment rate could struggle for further downward momentum in the near-term. Furthermore, the composite employment PMI averaged 53.9 in Q3 compared to Q2's 55.4. This point to a slower pace of employment growth.



Meantime, a sharp pick-up in wage growth has been a notable feature of the UK economy over the past 12 months. The data show that year-on-year growth in earnings (ex-bonus) has stalled since April, holding in a 2.7-2.9% range.

At the same time, **CPI inflation has been stuck at around 0% since February.** It remains weighed down by the impact from lower energy prices, as well as declines in the price of food. However, the upside to this is that it has helped to boost real wage growth and as such, it could support the already robust performance of consumer spending going forward.

In slight contrast to the decline in construction output in Q3, the housing market continues to show encouraging signs. The annual pace of growth in Halifax house prices remained around 9% in the third quarter, while the Nationwide measure of price inflation also picked up. Mortgage approvals improved further in Q3, while the volume of housing transactions has also continued to rise. The BoE has commented that the modest strengthening in the housing market should over time help support house-building.

UK survey data for October suggest that the economy retained its more modest pace of growth at the start of Q4. The composite PMI rose to 55.4, broadly in line with the Q3 average of 55.1. Meanwhile, the UK EC economic sentiment index fell to 108.3, below its Q3 average reading of 112.4.

Overall, **moderate employment growth, weak inflation, improved real wages, a stronger Eurozone economy and low interest rates all suggest that the UK economy should continue to grow at a reasonable pace.** It still faces some headwinds, though, including high household debt, fiscal tightening and the negative drag on trade from a stronger sterling, as well as slower growth in emerging economies. Thus, it is not completely surprising that GDP growth may be slowing towards 2%, from 3% in 2014.