BoE Watch

AIB Treasury Economic Research Unit

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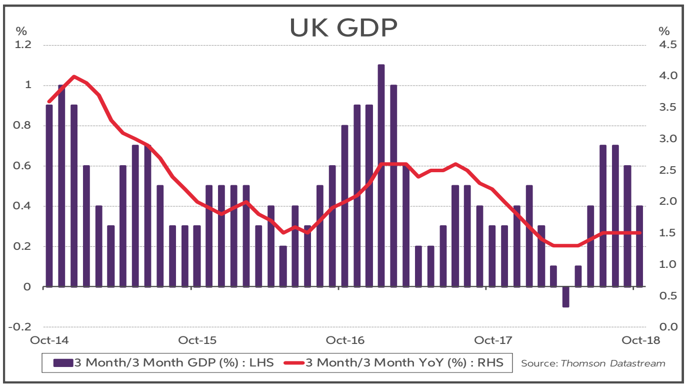
Market puts rate hikes on long finger as Brexit looms

As expected, the December meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The bank rate was left at 0.75%. It was last raised by 25bps at its meeting back in August. The decision today by the MPC to leave interest rates unchanged was unanimous.

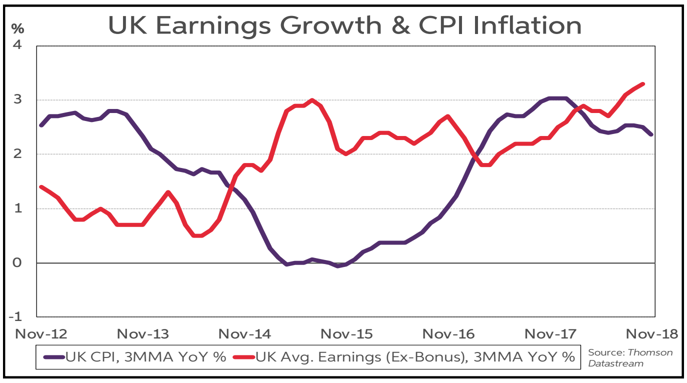
Today's meeting took place against the backdrop of heightened uncertainty in relation to Brexit. The post-meeting **statement noted that Brexit uncertainties had intensified considerably since the MPC's last meeting** at the start of November. It said these uncertainties are weighing on UK financial markets. It seems most unlikely that there will be any change in UK monetary policy until there is clarity on how Brexit will evolve.



The MPC observes that the further intensification of Brexit uncertainties, coupled with the slowing global economy, are weighing on the near-term outlook for UK growth. The most recent set of BoE economic forecasts were released last month with the publication of the Quarterly Inflation Report for November. These projections were based on the assumption of a "relatively smooth" Brexit. The economy was forecast to grow at steady rate of 1.7% over the next three years. Meanwhile, CPI inflation was forecast to remain above its 2% target for most of the forecast period, before reaching 2% by the end of the third year.

The MPC says that near-term **GDP growth is now likely to be slightly lower than it had expected, at 0.2% in the final quarter of 2018, and it could remain at this level in the first quarter of 2019**. As well as increased Brexit uncertainty, the MPC noted that global growth had softened sooner than expected, while financial conditions have tightened, particularly in the corporate debt market. However, on the other hand, the MPC judges that the loosening of fiscal policy in Budget 2018 will boost GDP by around 0.3% over the MPC's forecast period.

In terms of the inflation outlook, the MPC says that the recent marked decline in oil prices means that the short-term outlook for inflation is now weaker than previously predicted. The BoE now expects inflation to fall below its 2% target in January to around 1.75%, and remain below target over the following few months.



It notes, though, that domestically generated inflationary pressures have continued to build, pointing to accelerating wage growth in particular. It also noted that the loosening in fiscal policy will boost inflation slightly over the medium term.

Overall, the BoE is on hold for now as it awaits clarity on Brexit. In this context, the options facing the BoE look binary. In the event of a 'soft' or even a 'delayed' Brexit, the central bank is likely to hike rates, possibly as soon as May. However, if a no-deal 'hard' Brexit materialises, it is likely that the BoE would cut rates to help the economy cope with the negative economic impact, despite some signals from it to the contrary.

Futures contracts indicate that increased uncertainty over Brexit has impacted market rate hike expectations. The market is now anticipating that the BoE will not hike rates until mid-2020. This compares to its expectation of a rate hike by Q3 2019 at the time of the last BoE meeting. The markets do not envisage the next rate hike occurring until mid-2022. If a hard Brexit is avoided, these rate hikes will almost certainly be brought forward.

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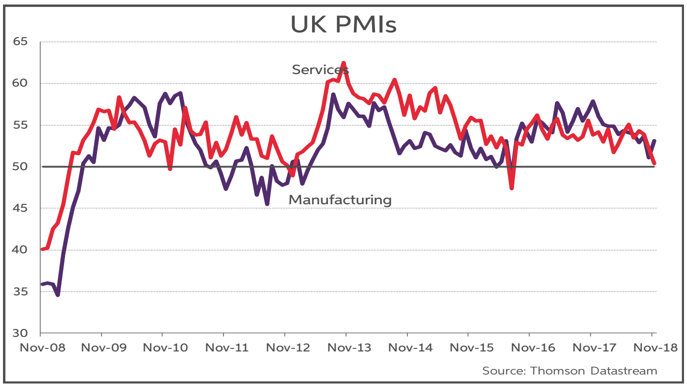
UK economy slowing sharply again

UK GDP rose by a strong 0.6% in Q3 2018, improving on Q2's solid 0.4% growth rate and Q1's anaemic 0.1% rise. The underlying data show that net trade was the primary driver of growth in Q3, adding 0.8 percentage points (p.p.) in the quarter. Personal consumption and government expenditure were solid, contributing 0.3 p.p. and 0.1 p.p. respectively. Meanwhile, gross capital formation (investment and changes in inventories) acted as a significant drag on growth, subtracting 0.6 p.p. from the quarterly total. **In a timelier update, the ONS' monthly GDP estimate indicates that the economy has lost some momentum in recent months.** GDP hardly grew in any of the three months to October, as the temporary boost to activity in early summer faded.

The limited 'hard' data that have been released for Q3 have been somewhat mixed. Retail sales have risen by a strong 1% to date in Q4 versus Q3, in which they also grew by 1%. However, the strong performance to-date in Q4 likely reflects some 'Black Friday' distortion. Indeed, the growth was exclusively driven by a month-on-month increase of 1.4% in November. Therefore, sales could fall back in December. On the production side of the economy industrial output declined by 0.6% in October, leaving the year-on-year growth rate in negative territory. Meanwhile, the trade deficit widened in the month, indicating that the external sector may weigh on growth in Q4.



Recent survey data have been similarly disappointing. The GfK measure of consumer confidence hit a year low level in November. Meanwhile, the Composite PMI dropped from 54.1 at end-Q3 to 50.7 in November, primarily due to a fall-back in the services component. Indeed, the services PMI was recorded at just 50.4 in November, compared to 53.9 in September, suggesting that growth in the sector has stagnated. The November reading of the manufacturing index was only marginally lower at 53.1 vs. 53.7 in September. Overall, the BoE estimates that GDP growth may have slowed to 0.2% in Q4.

Labour market data have been more encouraging. For instance, employment growth edged up in the 3 months to October to 1.2%, from 1.1%, in year-on-year terms. A similar sized expansion of the labour force meant the unemployment rate held at 4.1% in October, close to a multi-decade low. Looking forward, the ONS' measure of job vacancies is near a historic low level, suggesting that the labour market will remain tight.

The lack of slack in the labour market has manifested itself in accelerating wage inflation. The growth rate of underlying average weekly earnings picked up to hit 3.3% in the three months to October, its highest rate since December 2008. Meanwhile, inflation has moderated in recent months on lower oil prices, with headline CPI edging down to 2.3% in November. Therefore, there has been a welcome rise in real wages.

Overall, the outlook for the UK economy is highly uncertain. Its performance is contingent to a large degree on the nature of the UK's exit from the EU. Heightened uncertainty owing to Brexit in the coming months could act as a headwind to business investment, which is already very subdued, and may weigh on consumer sentiment. However, October's fiscally expansive budget, combined with a still very accommodative monetary policy stance, should help to support growth. The most recent BoE forecasts are for growth of 1.3% this year, followed by 1.7% in 2019 and 2020. These are more upbeat than the OECD's forecasts of 1.4% and 1.1% in 2019 and 2020, respectively. These forecasts are based on a smooth exit by the UK from the EU in March. A disorderly hard Brexit would result in much weaker growth in 2019 and beyond.