BoE Watch

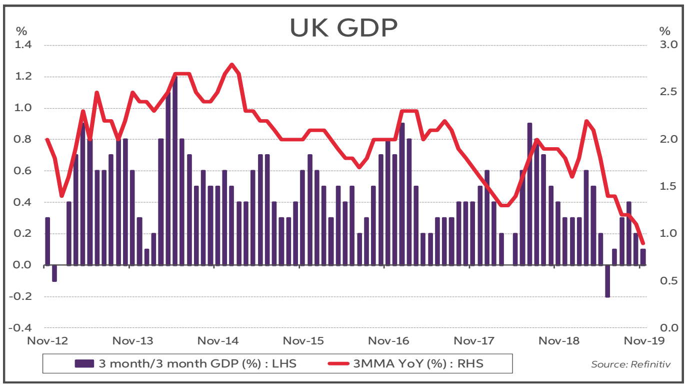
AIB Treasury Economic Research Unit

30th January 2020

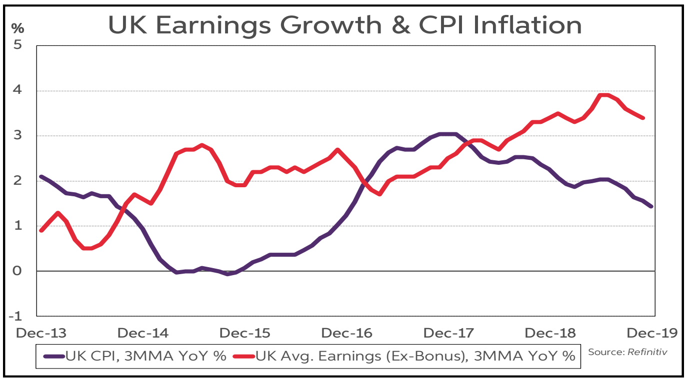
Reduced chance of near term BoE rate cut

The first Monetary Policy Committee (MPC) meeting of 2020 and the last with Mark Carney as Governor concluded with no changes to policy. The market was split on whether the BoE would cut rates or not**.** The Bank Rate, though, was left at 0.75%. For the third consecutive meeting, the decision to leave policy unchanged was not unanimous. Once again, members Haskel and Saunders voted for a 25bps rate cut, resulting in a 7:2 voting split. **However, this was less dovish than the market had been expecting** (a closer vote was anticipated). Overall, the majority view within the MPC was that the "existing stance" of monetary policy is appropriate.

Indeed, the text of the meeting statement and minutes suggest that the BoE has become somewhat less concerned about the economic outlook compared to the time of its December meeting. It noted that recent data suggest that global growth may have "stabilised", aided by the partial easing of trade tensions and the loosening of global monetary policy last year. **It also acknowledged that the domestic near term uncertainties (i.e. Brexit) facing households and business have "receded".** It noted an improvement in UK survey data (both business and consumer), some recovery in "investment intentions" and a strengthening in housing market indicators.



Today, also saw the release of the BoE's updated macro forecasts contained within the Monetary Policy Report for January. The macro projections are based on the assumption of an orderly and immediate move at end 2020 to a "deep free trade agreement" between the UK and EU. Its GDP forecasts represent a downgrading of the growth outlook. The BoE is now expecting GDP growth of 0.75% this year (previous f'cast was for 1.25%), rising to 1.5% (was 1.75%) in 2021. For 2022, the BoE is pencilling in growth of 1.75% (was 2.0%). The sharp cut to the 2020 forecast looks rather odd given that there is no change to the expected 2019 outturn and the Bank seems a bit more optimistic on the growth outlook.



In terms of the inflationary outlook, the Bank's latest forecast show that it envisages inflation reaching its 2% target by the end of 2021 and rising slightly above it by the end of 2022.

Obviously, there is still a high degree of uncertainty and risk surrounding Brexit and thus the Bank's forecasts. Specifically, the outcome of the EU/UK trade talks will determine the long term impact of Brexit. Therefore, against this backdrop, it is not surprising the BoE is keeping its options open regarding any future policy changes. It stated that some easing may still be required to "reinforce the expected recovery" in the UK economy if the recent improvement in both global and domestic activity indicators is not sustained. However, it also highlights the possibility that "further out", some "modest tightening of policy" might be needed to meet its inflation target.

Following today's BoE meeting, the market has interpreted the various updates as suggesting that a rate cut is now less likely in the near term. This is reflected in futures contracts moving out the pricing of a 25bps rate cut from early summer to the fourth quarter. The market continues to anticipate that it will be a "one and done" cut, suggesting it expects that the upcoming trade talks this year between the EU and UK will have a benign outcome for the economy.

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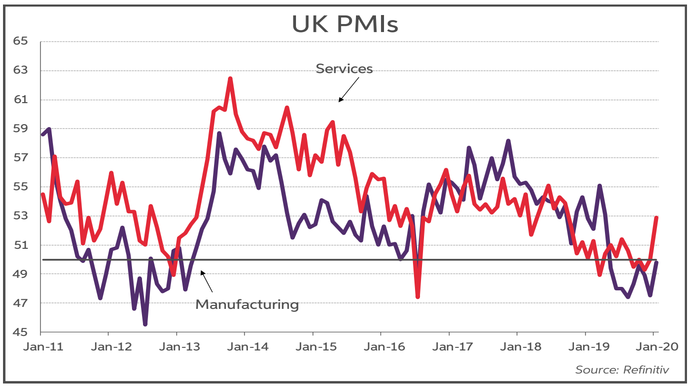
Pickup in UK activity may not last

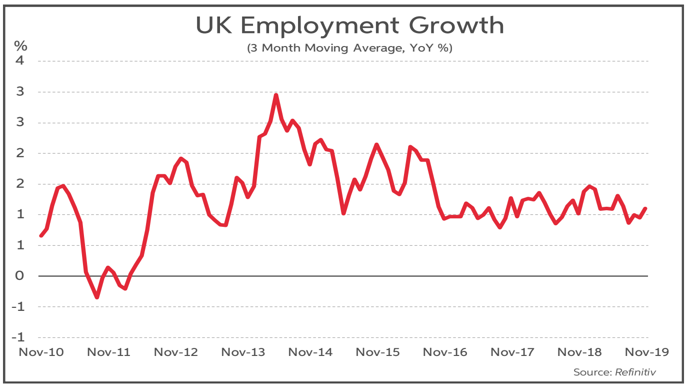
UK economic growth rebounded in the third quarter of the year, coming in at 0.4% following a contraction of 0.2% in Q3. The year-on-year growth rate, though, moderated to just 1.1%. In terms of the breakdown, net trade contributed a hefty 2.3 percentage points (p.p.) to the quarterly growth total. Although, this was mostly offset by an associated decline in inventories. With regard to domestic demand, consumer spending added 0.2 p.p., while fixed investment was flat. Government spending acted as a slight drag and took away 0.1 p.p..



The available 'hard' data for the final quarter of the year have been disappointing. The monthly GDP estimate, which is by the output method, contracted sharply in November, which left the rolling 3 month measure at just 0.1%. Services activity continues to drive growth, but has moderated. Meanwhile, the industrial sector remains mired in recession. On the demand side, retail expenditure has been very weak. In the quarter, sales volumes declined by 0.9% on Q3 levels.

Likewise, the PMIs suggested that the economy performed poorly in Q4. Indeed, the composite index was at or below the key 50 threshold throughout the quarter. The weakness was broad-based, with the construction, manufacturing and services PMI all at weak levels.

In contrast, the labour market has held up comparatively well. Despite an apparent softening in labour demand, as evidenced by a decline in vacancies, jobs growth has remained steady. In the 3 month period to November, it came in at 1.1% in year-on-year terms. This has helped keep the unemployment rate at its multi-decade low of 3.8%. Earnings growth has, though, been moderating. Underlying wage inflation was registered at a still strong 3.4% in November, but is down from a peak of 3.9% in the summer.



On the inflation front, decent wage gains have not led to a build-up in price pressures. Indeed, headline CPI moderated to a three year low of 1.3% in December. This reflected a sharp decelerated in the core measure, which eased from 1.7% in November to 1.4%, also a three year low.

With regard to January data, there has been some evidence that the Tories' resounding election win and the associated reduction in near term Brexit uncertainty has led to a pickup in activity. Notably, the composite PMI hit a 6-month high of 52.4, driven by improvements in both manufacturing and services. The CBI Industrial Sentiment survey was also recorded at a high level, with the investment intentions subcomponent rising sharply.

The pickup in activity, though, could well prove temporary. It is a positive that the threat of a no-deal Brexit at end January has been avoided. However, Brexit is likely to remain a headwind over the year as trade talks between the EU and the UK are expected to be difficult. Prime Minister Johnson has insisted that these will be concluded within one year, but this is an ambitious timeline to conclude any comprehensive FTA. Faltering trade talks, or indications that the UK is only interested in pursuing a bare-bones deal would hamper business confidence and investment. Indeed, there is a risk that the two sides will be unable to agree a trade deal. In this case, the UK may opt to leave the EU on WTO terms on December 31st, a de facto hard Brexit.

Brexit aside, the BoE looks set to maintain its accommodative policy stance, which will help growth. A more expansionary fiscal stance, as well as the solid labour market should also support activity. **Today's BoE forecasts are for growth of 0.75% in 2020, followed by 1.5% in 2021. This is more downbeat than the IMF's projection for GDP growth of 1.4% for 2020.**

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