BoE Watch

AIB Treasury Economic Research Unit

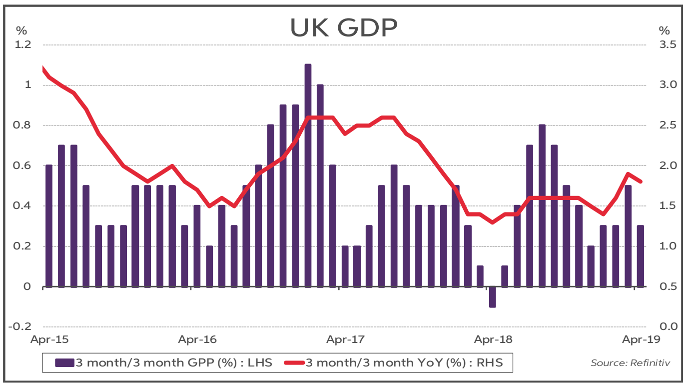
20th June 2019

BoE remains on hold amid Brexit impasse

The June meeting of the Bank of England Monetary Policy Committee (MPC) concluded as expected with no changes to policy. The bank rate was left at 0.75%. The decision to leave rates unchanged was unanimous. The last time the rate was altered was back in August 2018, when it was raised by 25bps.

The meeting statement and minutes were more cautious in tone than in May. In the meeting statement, the BoE noted that global trade tensions had "intensified". Meanwhile, the Bank said that the perceived risk of a no-deal Brexit had risen. The BoE also commented that while recent data had been "broadly in line" with its expectations, it had concluded that the "downside risks to growth have increased".

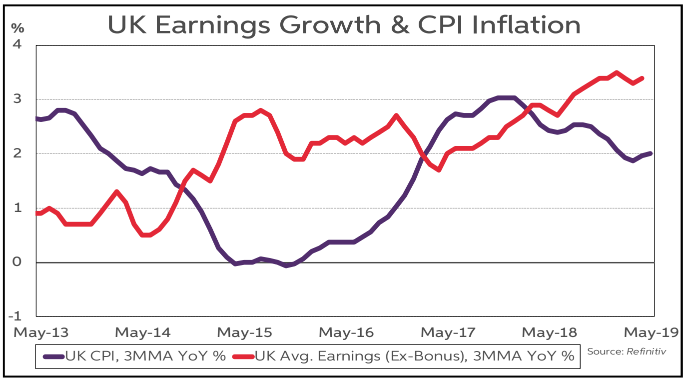
Meanwhile, in terms of the BoE's view on the UK economy, the meeting minutes showed that it had become more negative on the near term prospects for growth. The text outlined that it was now expecting the economy to stagnate (in May, it was forecasting 0.2% q/q) in the second quarter, in part due to "Brexit-related effects on financial markets and businesses". This includes the unwinding of the boost to quarter one GDP from stockpiling ahead of the original Brexit date of March 29th.



The BoE's most recent set of macro forecasts were detailed in last month's Inflation Report. The projections continue to be based on the assumption of a relatively "smooth adjustment" following the UK's exit from the EU. The BoE is expecting growth of 1.5% this year (previous f'cast was for 1.2%). However, given the downgrading of its forecast for Q2, this forecast is likely to be moved lower in its August Inflation Report. Further out, it is expecting the economy to grow by 1.6% in 2020 and 2.1% in 2021.

Meanwhile, in terms of the inflationary outlook, the MPC stated today that it expects inflation (at 2.0% in May) to fall back later this year, reflecting lower energy prices. However, in the May Inflation Report it outlined that it anticipates inflation, on the back of emerging excess demand and a firming in domestic inflation pressures, **will be above its 2% target in two years time and will still be on an upward trend at the end of its 3 year forecast horizon**.

In terms of market expectations, futures contracts indicate that the market is not anticipating any rate changes from the BoE for the next couple of years. At the time of its last meeting back in May, the market was pricing in one rate 25bps rate increase by the end of 2020, taking rates up to 1% and remaining at this level by the end of the BoE's three year forecast horizon in 2021. However, the market is now anticipating rates remaining at 0.75% during this period.



Overall, today's update from the BoE indicates that the Central Bank seems less inclined to hike rates than it was back at its May meeting. This is against a more challenging outlook, including rising global trade tensions, slower global growth, increased uncertainty surrounding Brexit and softer UK economic activity.

Today's more cautious sounding BoE is in keeping with the tone from other key central banks, including the Fed and ECB. However, it is somewhat surprising given the recent rate hike comments from a number of MPC speakers, including its Chief Economist. In short, the outcome of Brexit remains the key factor in determining the next move from the BoE. Till then, **the Bank is very much in wait-and-see mode.**

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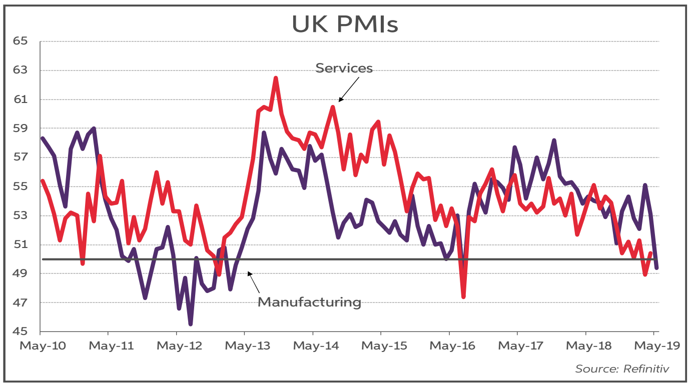
Weak start to Q2 as Q1 Brexit boost unwinds

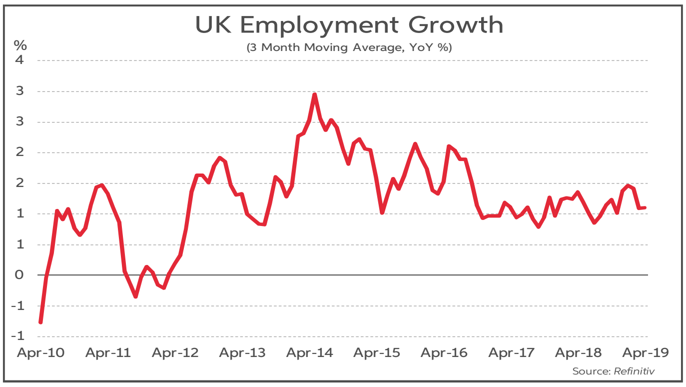


UK GDP expanded by a solid 0.5% in the opening quarter of 2019, leaving the year-on-year growth rate at 1.8%. The underlying data shows that this was in large part due to the impact of stockpiling ahead of the original Brexit date, adding 1.6 percentage points (p.p.) to growth. Although, consumer spending was also strong (+0.4 p.p.). Business investment rose for the first time in a year, though only marginally.

In terms of timelier updates, the latest monthly GDP estimate showed growth slowed from 0.5% to 0.3% in the three months to April. GDP actually contracted, for a second consecutive month, in April, falling by 0.4%, suggesting firms scaled back activity after the aforementioned Brexit related boost in Q1. There is further evidence of this in the industrial production numbers. Headline output fell by 2.7% in April, while the key underlying manufacturing sector contracted by 3.9%. One noteworthy source of weakness was in relation to vehicle production, which plummeted 24% (UK based car manufacturers brought forward their normal two week stoppage from August to early April in case there had been a hard Brexit at end March).

The other available 'hard data' for the quarter have also been downbeat. Retail sales fell in both April (-0.1%) and May (-0.5%), although this followed very strong sales volumes in March that may have been linked to households stockpiling ahead of Brexit. Meanwhile, the goods deficit narrowed in April after the boost to imports in earlier months due to pre-Brexit purchases/planning reversed.

Survey data also suggest that economic activity has moderated in Q2. The manufacturing PMI has dipped for two consecutive months, most recently to below the 50.0 level in May, as the impact from Brexit related stockpiling in the opening months of the year unwound. Meanwhile, the services PMI averaged 50.5 in April/May, a slight improvement on Q1's 50.1, but consistent with a subdued level of activity. On the household side of the economy, though, the GfK measure of consumer confidence index rose to an 8-month high in May.



Labour market data for the three month period to end-April were reasonably solid. The jobless rate held at just 3.8%, a multi-decade low level. Meanwhile, employment maintained its 1.1% yearly growth rate, with the employment rate remaining at a joint-record high of 76.1%. **The tight labour market conditions have seen underlying wage inflation pick up to 3.4% yoy this spring.** Despite this, price pressures have remained relatively contained in recent months, with the CPI rate standing at 2% in May.

Overall, the outlook for the UK economy remains highly uncertain. Until a clearer picture on Brexit emerges, such uncertainty will continue to act as a headwind to business investment. At the same time, the slowdown in global growth may also act as a drag. However, on a more positive note, the BoE looks set to maintain its accommodative policy stance this year. Last October's fiscally expansive budget, as well as the strong labour market which has aided consumer spending. **The most recent BoE forecasts are for growth of 1.5% in 2019, followed by 1.6% in 2020. These may prove overly optimistic. The OECD's projections are for 1.2% GDP growth in 2019 and 1.0% in 2020**. These forecasts are based on a smooth exit by the UK from the EU. A disorderly hard Brexit would result in much weaker growth in 2020 and beyond.

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