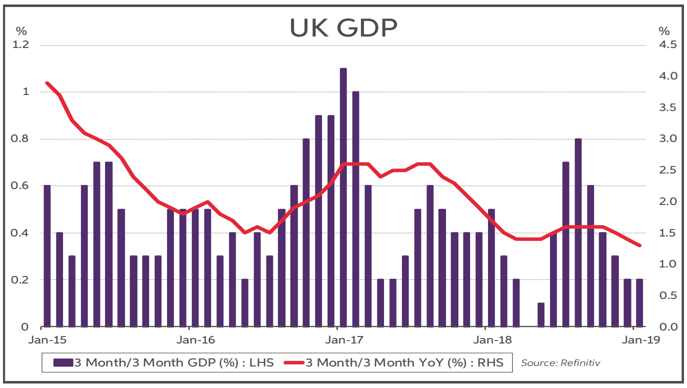
21st March 2019

BoE on hold, awaiting Brexit outcome

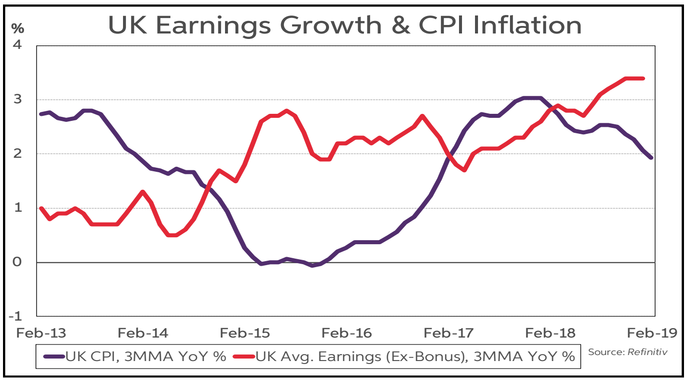
As expected, the Bank of England Monetary Policy Committee (MPC) meeting for March concluded with no changes to policy. The bank rate was left at 0.75%. It was last raised by 25bps at its meeting back in August 2018. The decision today by the MPC to leave interest rates unchanged was unanimous. **The MPC stated that underlying inflationary pressures appeared to be broadly on track with its current projections, which were outlined in the February Inflation Report.**

Both the meeting statement and minutes highlighted that the outcome of Brexit will be the key determining factor in any policy changes that the BoE implements. Indeed, the MPC continued to emphasise today that the monetary policy response to Brexit "could be in either direction" as the UK economy's outlook will "depend significantly" on the nature/timing of the country's exit from the EU.



The minutes detailed the discussion within the MPC in relation to the impact that Brexit uncertainty is currently having on the economy. It stated that this included a dampening impact on confidence and economic activity levels, especially in relation to business investment. While the MPC acknowledged the recent strength in employment growth, it said that survey indicators suggest a softening in the outlook for the jobs market. Meanwhile, in terms of the household sector, it characterised consumer spending data as being "consistent with ongoing modest growth".

Overall though, while recent macro data have been "mixed", the BoE's assessment was that the economy was evolving broadly in line with its forecasts from its most recent Inflation Report. In this regard, the BoE is expecting growth of just 1.2% this year, 1.5% in 2020 and 1.9% in 2021. Meanwhile in terms of the inflationary outlook, the MPC expects CPI inflation to fall slightly below its 2% target in the near term. However, it still envisages it settling "a little above the target" over the medium term. These projections are based on the assumption of a "relatively smooth" Brexit transition for the UK economy.



In terms of market expectations, futures contracts indicate that the market is not anticipating any rate hike this year. Indeed, contracts suggest that the market is not envisaging a rate increase until around the second half of 2021, taking rates up to 1%. These contracts though have moved quite significantly in recent days. Just last week, futures contracts were pricing in the next rate increase for around September 2020.

In conclusion, the BoE's assessment is that the economy will not likely require any rate hikes in the near term. This is against the backdrop of heightened Brexit uncertainty and the BoE's expectation for a weaker near term economic outlook. However, over the medium term, it expects that excess demand will likely build resulting in above target inflation. As a result, the MPC maintains its view that a gradual ongoing tightening of monetary policy will be appropriate over the next 2-3 years to "return inflation sustainable to the 2% target". It is important to note, though, that inflation is expected to remain above its target in 2020 and 2021. **Therefore, in the event of a soft Brexit, the BoE could tighten policy considerably earlier than markets currently expect.**

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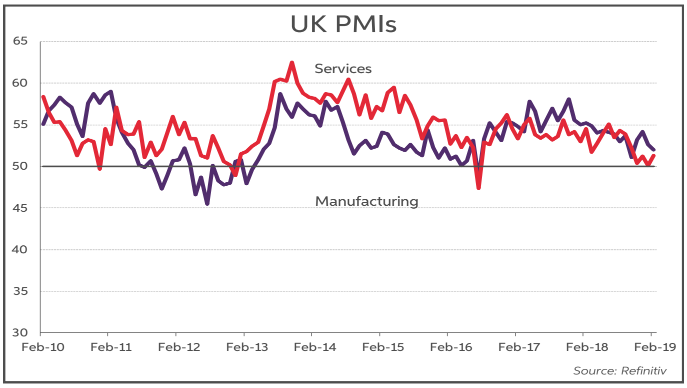
Brexit weighing on UK growth

The UK economy lost momentum towards the end of 2018. Quarterly GDP growth slowed from 0.6% in Q3 to just 0.2% in the final quarter of the year. This left the average growth rate for 2018 at 1.4%, down from 1.8% in 2017.



Heightened Brexit uncertainty appears to be the main cause of the recent slowdown. Underlying Q4 GDP data shows that business investment has fallen for 4 straight quarters and subtracted 0.1 percentage points (p.p.) from growth in Q4. Similarly, an increase in imports, in part due to stockpiling, lead to net trade also taking away 0.1 p.p. Household and government expenditure were the main drivers of growth in the quarter, contributing 0.25 p.p. each.

Survey data suggests that economic activity has remained subdued in the opening quarter of 2019. The PMIs, which have tended to understate UK GDP growth in recent months, indicate that growth has failed to regain momentum. The manufacturing index came in at 52.3 in January / February, versus 52.8 in Q4, while the key services PMI averaged 50.7 in the opening 2 months of the year, against 51.3 in Q4. At the same time, the EC measure of UK economic sentiment has continued to weaken in early 2019. It was recorded at 99.2 in February, compared to a reading of 105.4 at end-2018.

However, labour market data for the three month period to end-January were encouraging. Employment growth picked up in the period with the year-on-year rate edging up to 1.5%, from 1.4%. Meanwhile, the jobless rate dipped to 3.9%, a multi-decade low level.

The lack of slack in the labour market appears to be manifesting itself in higher wage inflation. The yearly growth rate of underlying earnings was recorded at 3.4% in January, a joint 10-year high. Although, price pressures have remained relatively contained in recent months, in part due to lower energy prices. Headline CPI inflation edged up slightly in February, but only to 1.9%, just below the BoE's 2% target level.

The available 'hard' data for Q1 paints a mixed picture of the UK economy. The estimate of GDP in the 3 month period to end January also put growth at 0.2%, suggesting activity has not rebounded at the beginning of Q1. Meanwhile, retail spending has been reasonably strong despite heightened Brexit uncertainty, as the recent boost to real wages has increased household spending power. The most recent sales report showed that expenditure has risen by 1.0% on Q4 levels. On the output side of the economy, the impact of Brexit is more notable with industrial production having declined by 0.9% in January. At the same time, the goods trade deficit also widened.

Overall, the outlook for the UK economy is highly uncertain. The economy's performance is contingent to a large degree on the nature of the UK's exit from the EU. Until the final outcome becomes clearer, uncertainty will continue to act as a headwind to business investment and may also begin to weigh on consumer spending. Although, 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 1.2% in 2019, followed by 1.5% in 2020, which are in line with the OBR's projections of 1.2% GDP in 2019 and 1.4% in 2020. However, 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 2019 and beyond, as evidenced in a BoE study.

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