BoE Watch

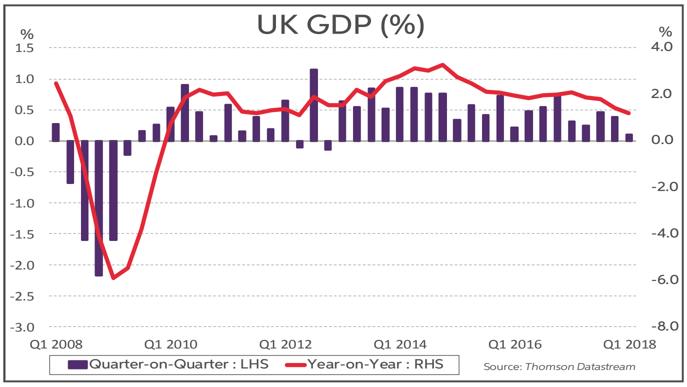
AIB Treasury Economic Research Unit

10th May 2018

Timing of next rate hike is data dependent

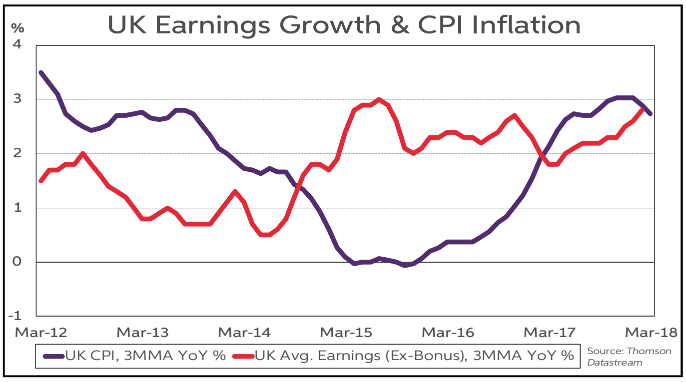
The May meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The key Bank Rate was left at 0.5%. Two MPC members, voted for an immediate hike of 25bps, as was the case in March. The outcome was in line with market expectations. Up to a few week's ago, there had been increasing speculation of a rate hike this month. However, a raft of weaker than expected data, as well as more cautious comments from Governor Carney, had greatly reduced the possibility of a rate increase in May.

The statement and minutes outlined the Bank's rationale for leaving rates on hold. Given the weak first quarter, the majority of members placed "value in seeing how the data unfolded over the coming months". This would allow them to "discern" if the "softness in Q1 might persist". Overall, based on their assumption that only limited monetary tightening would be required over the next 2-3 years, they viewed the consequences of waiting for additional information as likely being negligible, in terms of achieving their 2% inflation target.



The broad view within the MPC from today's various updates was that the BoE is not overly concerned by the weaker start to the year for the UK economy. The statement, minutes and Governor Carney's press conference comments all generally emphasised the BoE viewed that the slowdown in Q1 would prove temporary. They noted the weather impact in the quarter, as well as referencing survey data that "suggested that growth had been somewhat stronger in Q1 than implied by the preliminary estimate". Indeed, its central view is that Q1 growth would be revised up to 0.3%. Meanwhile for Q2, the Bank is envisaging quarterly growth of 0.4%.

More details on the BoE's latest macro forecasts were contained in the May edition of its Quarterly Inflation Report. The MPC downgraded its 2018 GDP forecast to 1.4% (from 1.8%). However, despite the downward revision to this year, the BoE left its growth forecasts for 2019 and 2020 unchanged at 1.7%. Meanwhile, in terms of the inflation outlook, while the BoE expects near term inflation to be somewhat lower than previously forecast, its medium term view was "only a little lower", reaching the 2% target "in two years".



The Bank of England continues to face a complicated backdrop as its debates the appropriate stance of monetary policy. While inflation appears to have peaked at around 3%, with the CPI rate easing back to 2.5% in March, it is still running above the 2% target. Meanwhile, given its analysis on the output side of the economy, where supply growth is projected to be around 1.5% annually, the MPC continues to judge that the economy has "a very limited degree of slack". However, at the same time, Brexit and the slowdown in the UK economy add further complications to its policy deliberations.

Data over the coming months will play a key role in determining the timing of the next rate hike from the BoE. A rate increase before the end of summer cannot be ruled out. Futures contracts are fully pricing in a 25bps increase by the end of the year. Meanwhile, the MPC indicated today that it was content with the markets view of three hikes over the next three years. This would leave the Bank Rate at a still low 1.25% by end 2020. Following today's 'wait-and-see' approach from the BoE, interest rate futures contracts softened somewhat and gilts yields moved lower, with the policy sensitive 2-year yield down around 7bps. Meanwhile sterling was weaker, falling by around 1% on the day, with EUR/GBP back above the 88p mark.

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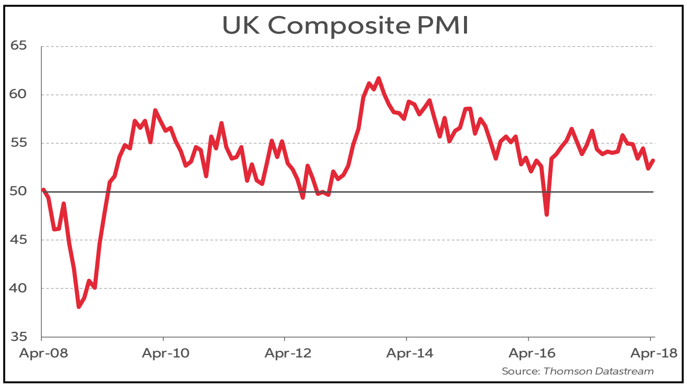
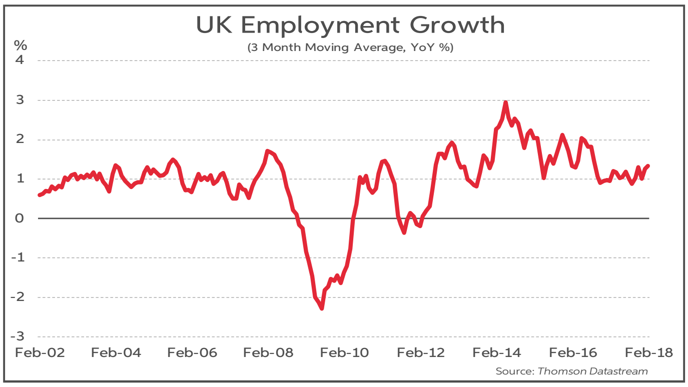
UK growth continues to slow



UK GDP rose by just 0.1% in Q1 2018, its weakest quarterly performance since Q4 2012. This followed on from +0.4% in Q4 2017 and +0.5% in Q3. The pace of year-on-year growth slowed for a fourth consecutive quarter in Q1, to a six-year low of 1.2%.

While extreme weather conditions in the first quarter played a part in the weaker growth, the ONS notes that "the effects were generally small". Underlying data show that the services sector remained the source of most growth in the UK in Q1, adding 0.2 percentage points (p.p.). Within the services sector, 'business services and finance' continued to be the main driver, adding 0.14 p.p. Production contributed 0.1 p.p. for a third consecutive quarter. The construction sector deducted 0.2 p.p. in Q1, with output down in all three months in the quarter, not just during March's period of heavy snowfall.

Meanwhile, **labour market data show that while employment increased by a relatively modest 55k in the three months to February, after increasing by 102k in the three months to November, the pace of year-on-year growth held at 1.3%.** At the same time, a small 39k increase in the size of the labour force in the three months to February meant that the unemployment rate declined to 4.2% in the period, its lowest level since 1975. **Other indicators suggest that labour market 'slack' has continued to dissipate, with the BoE's Business Conditions survey showing that difficulty in recruiting workers was at its highest level in Q1 in over 13 years.**



The tighter labour market has shown some signs of translating into firmer wage growth. Average weekly earnings rose by 2.8% year-on-year in the three months to February, compared to a rate of 2.2% in the same period in 2017. However, CPI inflation has moved downwards in recent months, falling to 2.5% in March as the impact of sterling's decline wanes. **This points to a return to modest growth in real wages.**

In terms of the performance of the UK economy at the start of Q2, the Composite PMI, which was negatively impacted by the aforementioned weather conditions in March, saw some improvement. Although, at 53.2 it suggests that the economy continues to grow at a more modest pace (Q1 average 53.4). Meanwhile, **the EC measure of UK Economic Sentiment continued to move lower in April, coming in at 104.9, a 19-month low.** The CBI distributive trades survey, a leading indicator of the performance of the retail sector, was also weak in April, while the BRC measure of retail sales showed a 4.2% fall year-on-year in April.

Overall then, the outlook for the UK economy remains challenging. It continues to be impacted by the uncertainty associated with the UK/EU negotiations on Brexit. Investment may remain subdued, while largely stagnant real wages will weigh on consumption. At the same time, the still relatively weak sterling and encouraging growth in the UK's main export markets should eventually have a positive impact on trade, while the BoE is set to keep policy very accommodative.

The UK Office for Budget Responsibility latest updated growth forecasts, show the economy expected to grow quite modestly in the coming years. The OBR is projecting that GDP will rise by 1.5% this year, followed by increases of 1.3% in both 2019 and 2020. Today's updated BoE forecasts include a downgrade to its 2018 forecast to 1.4% (from 1.8%), while its 2019 and 2020 forecasts were left unchanged at 1.7%

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