

BoE on hold for now, awaiting Brexit clarity

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

The release of the Quarterly Inflation Report today provided more details on the BoE's view of the outlook for the UK economy. These economic projections are based on a "relatively smooth" Brexit transition. Governor Carney noted in the press conference that as the deadline for the UK/EU exit talks approaches "households are more sanguine, while businesses are more wary".

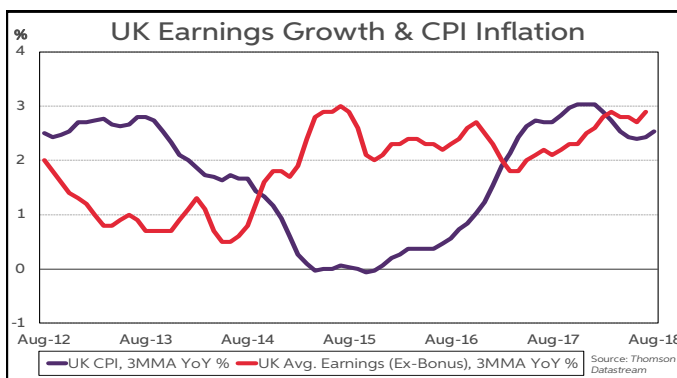
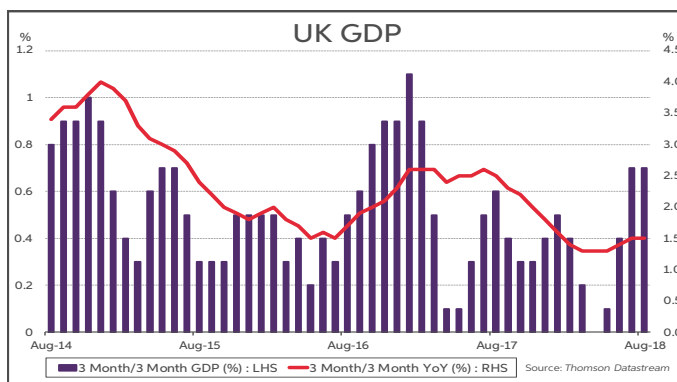
In terms of its growth projections, the MPC revised slightly lower its 2018 GDP forecast to 1.3% (from 1.4%). It also modestly revised down its 2019 GDP expectation to 1.7% (from 1.8%). It left its 2020 GDP projection unchanged at 1.7%, while its first published forecast for 2021 shows that the BoE is anticipating GDP growth of 1.7%. It must be noted that these projections do not take account

of the recent Budget measures which are expected to provide a modest boost to growth. The BoE stated that these measures would be assessed for their implications at its next meeting. Meanwhile in terms of its inflation outlook, the BoE is anticipating that inflation is likely to remain above its 2% target for much of the forecast period.

While the BoE is on-hold in the near-term, it retains a clear tightening bias. However, it is awaiting the outcome of the Brexit negotiations and the implications these negotiations will have for the UK's economic outlook before deciding when to make further changes to its interest rate policy. The BoE's tightening bias is based on its assessment that GDP is forecast to grow by around 1.75% per year on average over its forecast period. This is slightly faster than the rate of supply growth, which it is projecting to average around 1.5% per year. As a result, the BoE envisages the economy moving into 'excess demand' by late-2019, resulting in increased domestic cost pressures. It is anticipating that inflation will "remain above target for most of the forecast period". Governor Carney also pointed out that given the weakness in productivity growth, wage growth "doesn't need to be as high as its pre-crisis average for unit labour costs to be consistent with meeting the inflation target". Therefore, the BoE expects its base case scenario to warrant further rate hikes in order to return inflation sustainably to its 2% target. Although, it continues to guide that any future increases in interest rates were likely to be at a "gradual pace and to a limited extent".

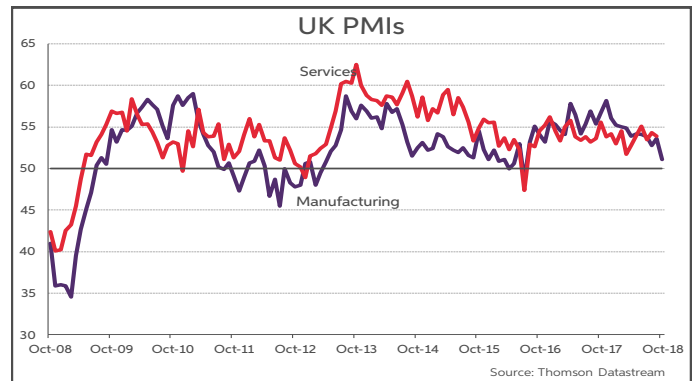
Futures contracts indicate that the market is

pricing in the next rate hike for Q3 2019, which implies that the market is also expecting a soft Brexit. Two further rate hikes are expected in 2020 and 2021. This would bring the Bank rate up to a still low 1.5% by end-2021. However, the UK economy has regained some momentum recently. The labour market has tightened considerably, reflected in the rate of wage growth rising above 3%, while at the same time inflation remains above target. Therefore, in the event of a soft Brexit, there is the possibility that the BoE could tighten policy by more than the market currently envisages. On the other hand, if a no deal/hard Brexit materialises, then rates could be cut next year.



UK economy growing at a moderate pace

UK GDP rose by 0.4% in Q2 2018, improving after Q1's disappointing +0.2% result. The underlying data shows increased inventories (+0.7 percentage points) and consumption (+0.2 p.p.) drove growth in the quarter. However, net trade was a significant drag (-0.6 p.p.), while investment and government expenditure were essentially unchanged on the quarter. Year-on-year growth remained modest in Q2 at just 1.2% (Q1 1.1%).



The ONS' new monthly GDP estimate shows that the economy may have picked up further momentum in Q3 2018. Growth was recorded at 0.7% in the three months to August, the strongest rate since February 2017, due to broad based growth across the three main sectors (construction, production, services).

In terms of other measures of UK activity in Q3, the hard data have also been generally positive. Retail sales grew by a strong 1.2% in Q3. Although, this represents a slight moderation on Q2 when sales increased by 2.0%. The deceleration was largely due to fall-back in food expenditure in September. On the production side of the economy, industrial output rose by 1% in July/August against Q2, aided by an improvement in the manufacturing sector. Net trade looks set to provide a boost to Q3 GDP growth, largely due to a substantial narrowing of the goods-trade deficit in July.

Recent survey data also suggest that the expansion of the UK economy is continuing at a solid pace. The Composite PMI averaged 53.9 in Q3, broadly unchanged from Q2's reading of 54.3. The key services PMI remained steady in the period, while the manufacturing component registered a slight fall in August before recovering much of the lost ground in September. However, this move looks to have been reversed again in October, with the manufacturing PMI falling back to 51.1, suggesting the sector has had a slow start to Q4.

On the labour market front, **employment growth has slowed, rising by just 0.5% on the year.** However, the ONS' measure of job vacancies is close to a historically high level indicating that weak employment growth may in part be reflecting a lack of available workers. This is reinforced by the fact that the unemployment rate edged down to just 4.0% during the period.



The tighter labour market appears to be starting to translate into firmer wage growth. Average underlying weekly earnings increased by a strong 3.1% on an annualised basis in the three months to August, its highest rate since January 2009. Meanwhile, with CPI inflation softening in recent months (at 2.4% in September), the rise in earnings has provided a welcome boost to real wages.

While the UK economy has showed signs of some improved momentum recently, the outlook remains challenging. Its performance is ultimately 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 at a subdued level, and may weigh on consumer sentiment. However, the government's recent budget initiatives, combined with a still very accommodative monetary policy stance, should help to support growth. Today's revised BoE forecasts are for growth of 1.3% this year, followed by 1.7% in 2019. These are broadly similar to the recent GDP forecasts from the Office for Budget Responsibility of 1.3% and 1.6% in 2018 and 2019 respectively.

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