

BoE holds at 3.75% but opens the door to rate hikes

The second policy setting meeting of the year of the Bank of England's Monetary Policy Committee (MPC), saw the central bank leave the Bank Rate unchanged today, at 3.75%. This outcome was very much in line with market expectations. The most recent rate cut from the BoE occurred at its December meeting, when it lowered the Bank Rate by 25bps. This represented the fourth 25bps rate cut from the BoE last year. So far in its current easing cycle, which began in August 2024, the BoE has lowered rates by 150bps in total.

In contrast to its recent policy decisions though, there was unanimity within the MPC today, as all nine members voted to leave rates unchanged. It was the first unanimous decision from the committee since 2022. Previously, four members of the committee had been in favour of cutting rates. This time around though, the same four members saw value in "pausing", to assess the economic impact of the conflict in the Middle East. However, some officials were keen to point out that if disinflation is simply "slowed" instead of "derailed", it may be appropriate to resume rate cuts. Meanwhile, several members of the MPC noted that they are "ready to act" to ensure inflation moves back to the 2% target, suggesting a willingness to hike rates if necessary.

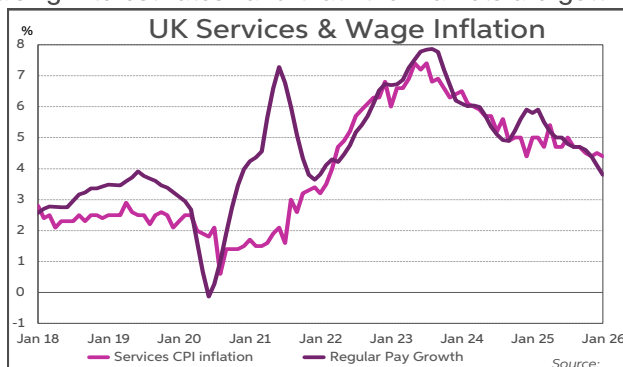
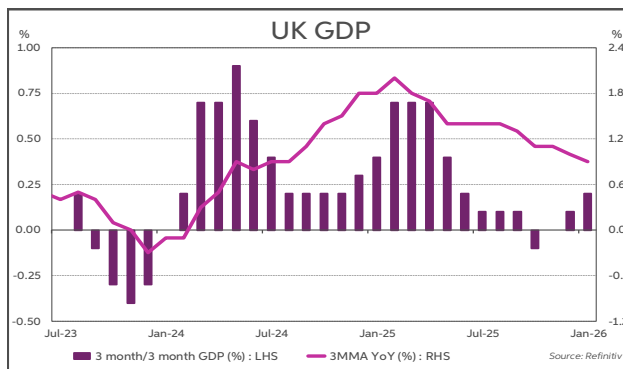
The updated meeting statement and minutes also leaned in a hawkish direction. In a marked change from previous editions, the statement no longer states that the "Bank rate is likely to be reduced further". Indeed, the statement is direct in its assessment, noting that "CPI inflation will be higher in the near term" as a result of higher fuel and energy costs. Furthermore, the minutes highlight that the MPC is "alert to the increased risk of domestic inflationary pressures through second-round effects in wage and price setting". **Meanwhile, the minutes also referenced revised near term inflation expectations due to the conflict in the Middle East.** The BoE no longer expects inflation to continue on a downward path, and is instead pencilling in CPI inflation to average 3.0% in Q2, with the potential for it to rise to 3.5% in Q3. In the most recent quarterly Monetary Policy Report, which was released at the last meeting in February, it was forecasting CPI to average 2.1% and circa 2.0%, respectively, over the same period.

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Assessing the text of the meeting statement, the minutes, and the rare unanimous vote from the MPC, it is clear that the conflict in the Middle East could bring the BoE easing cycle to an abrupt halt. Furthermore, the BoE appears to be highly attentive to the risks of second round price pressures stemming from higher energy prices. In this regard, several MPC officials noted that the BoE will have more data at the time of its next meeting at the end of April, when it is due to publish its updated Monetary Policy Report containing its full assessment of the economic outlook.

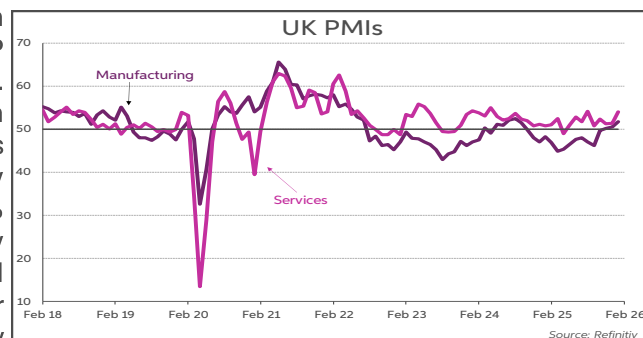
In the initial aftermath of today's policy announcement/minutes, futures contracts hardened markedly. At one point the market was pricing in up to three rate hikes from the BoE this year. Prior to today's meeting outcome, futures contracts were pricing in up to two rate hikes this year. Yet before the conflict in the Middle East erupted, the focus had been on potential rate cuts from the BoE, amid a recent deterioration in the labour market and a slowdown in inflation. Perhaps this explains why, in a statement provided an hour and a half after the release of the policy announcement, Governor Bailey appeared to pushback against market rate expectations, stating, "I would caution against reaching any strong conclusions about us [the MPC] raising interest rates" and that "the markets are getting ahead of themselves in assuming rate rises".

Since then, market rate expectations have softened somewhat, albeit the market is still pricing in at least two rate hikes this year. Overall, it is quite clear the BoE wants to take more time to fully assess how the Middle East conflict will impact the economy, meaning policy may remain on hold for an extended period of time. However, the meeting minutes show that the BoE will be highly attentive to any second round impacts on inflation from higher energy prices, and the MPC has flagged a willingness to hike rates if necessary. Thus, the upside risks to UK rates has risen following today's meeting.



Spike in inflation may weigh on tepid UK growth

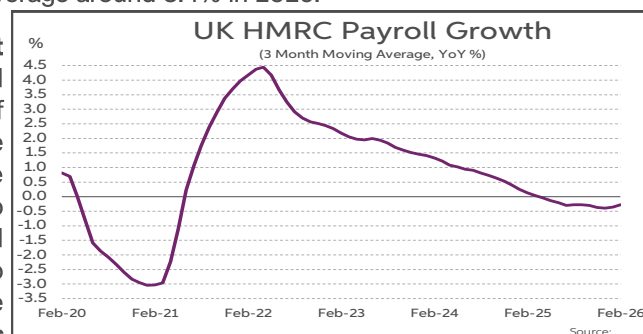
The UK economy gathered some momentum in 2025, particularly in the first half of the year. GDP rose by 0.7% q/q in Q1 and by 0.2% q/q in Q2. However, growth slowed markedly thereafter, with GDP rising by just 0.1% q/q in the final two quarters of the year. Overall, the UK economy expanded by 1.3% in 2025, up from 1.1% in 2024 and just 0.3% in 2023. Crucially, GDP per capita increased by 1.0% in 2025, having flatlined in 2024 and contracted by 1.0% in 2023. Solid consumer spending, a marked rise in investment - especially business investment, and higher government spending, all contributed to the rise in growth last year. Net trade was a drag on GDP, as imports rose at a sharper pace than exports.



Worryingly though, the limited available hard data for January have been weak. The monthly reading of GDP for January indicated that activity levels stagnated. Elsewhere, industrial production, which has been volatile recently, contracted for a second consecutive month. It declined by 0.1% in January, following a 0.9% fall at the end of last year. At the same time, retail sales surged by 1.8% in January, having contracted by 0.5% in Q4 2025. **In contrast, the available survey data suggest that the economy has gathered some steam in the first quarter.** The manufacturing PMI improved in January, reaching its highest level since August 2024, at 51.8. Furthermore, it was little changed at 51.7 in February, suggesting a similar pace of expansion in the sector. Similarly, the services PMI jumped sharply to 54.0 in January and printed at a similar level (53.9) in February. Meanwhile, consumer confidence rose to -16.0 at the start of the year, its highest level since August 2024, although it then deteriorated to -19.0 in February.

In terms of the labour market, conditions have softened over the past year. The unemployment rate increased steadily, from 4.4% at the start of the year to 5.2% in December. It should be noted that this is the highest jobless rate since January 2021. Furthermore, it remained at 5.2% in January. Worryingly, payrolls have contracted in eleven of the past sixteen months to February. Against this backdrop, wage inflation has cooled, but it remains elevated. Average earnings growth fell to +3.9% y/y in the three months to January. Other measures of wage inflation point to lower earnings growth also. Indeed, the BoE Agent's Summary Survey for Q1 suggests that pay settlements may average around 3.4% in 2026.

Meanwhile, inflation has fallen sharply in recent months. Both headline and core inflation jumped higher last April, owing to a number of one-off factors, before rising further during Q2 and the early part of Q3. Having reached 3.8% in Q3, the headline rate dropped sharply in Q4 and again to 3.0% in January. Meantime, the core rate also fell from a peak of 3.8% in the early part of 2025 to 3.1% in January of this year, its lowest level since September 2021. **However, the BoE has revised its near term inflation forecasts markedly higher due to the conflict in the Middle East.** The BoE now sees the headline rate running at 3% on average in Q2 (was 2.1%), and notes that it could rise to circa 3.5% in Q3.



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In summary, the UK economy enjoyed a solid start to 2025 but growth moderated in the second half of the year. At the same time, conditions in the labour market deteriorated, resulting in the unemployment rate moving back up above 5%. Meanwhile, inflationary pressures were continuing to cool at the start of 2026, which had opened the door to further rate cuts this year. **However, the emergence of the war in the Middle East now poses a significant risk that inflation spikes higher once again, which would remove the potential for any rate cuts this year.** At the same time, the UK economy continues to lack a coherent growth strategy, with little in the Autumn Budget or recent Spring Statement that is likely to alleviate the UK's ongoing problem of weak productivity. Thus, the IMF is forecasting tepid GDP growth of 1.3% and 1.5% this year and next. However, it should be noted that these forecasts were compiled before the war in the Middle East started, meaning there are downside risks to this outlook.

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