Market Bulletin

8 February 2018

Bank of England: Less willing to tolerate inflation above target

In brief

- The Bank of England (BoE) held its policy steady in February. The key interest rate was maintained at 0.5% and there were no changes to the asset purchase programme.
- The economy is now forecast to grow 1.8% this year, an upward revision from 1.6% forecast in November. Growth—which is meagre by historical standards—is still judged to be above trend so the BoE are increasingly nervous that inflation will not return to target.
- As a result there was a clear signal that the Bank judges it appropriate to increase the interest rate both sooner and by more than the market had priced. Prior to the meeting the market was expecting only 75 basis points (bps) of further hikes between now and 2020. A 25bps rate hike now looks likely in May.

EXHIBIT 1: Bank of England GDP and inflation forecasts

	GDP (y/y)			CPI inflation (y/y)		
Meeting	2018	2019	2020	2018	2019	2020
Nov-17	1.6%	1.7%	1.7%	2.4%	2.2%	2.1%
Feb-18	1.8%	1.8%	1.8%	2.4%	2.2%	2.1%
Change	0.2%	0.1%	0.1%	0.0%	0.0%	0.0%

Source: Bank of England, J.P. Morgan Asset Management. Data as of 8 February 2018.

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Growth revised up but thanks to strength elsewhere

The BoE upgraded its forecast for the UK economy marginally in its latest set of projections. It now expects annual GDP growth to be steady at 1.8% (see table for full set of BoE growth and inflation forecasts). The upgrade was largely due to the strength in activity elsewhere in the world. It was noted that global growth is now at the strongest pace in seven years and this is supporting UK activity. Half of all the growth registered in 2017 was due to net trade. Consumer spending is still expected to remain relatively subdued and investment modest whilst Brexit uncertainty continues. In other words, though growth might be better, for the average UK household, it might not feel like it.

The Committee also conducted its annual review of the supply side of the economy and concluded that potential growth is a meagre 1.5%. This is well shy of the potential rate of growth pre-crisis which was well north of 2%.

Putting it together—stronger demand and weaker supply means there are more inflationary pressures in the economy. Coupled with higher oil prices keeping inflation elevated near term, the Bank are clearly increasingly uncomfortable about inflation remaining above its target. The two hikes by the end of 2020 that the market had priced prior to the November inflation report were now not deemed by the Committee to be likely to be sufficient to bring inflation back to target. Policy would now need to be tightened "somewhat earlier and by a somewhat greater extent" than had been priced in November.

As a result, if events unfold as the Monetary Policy Committee currently project—growth of 0.4% quarter on quarter in Q1 and ongoing progress in the Brexit negotiations—then we should expect a 25bps hike in May and another 25bps before the end of the year. The Governor was keen however to temper expectations, reinforcing the message that the peak of rates is still expected to be well below the 5% we had been used to before the crisis.

Investment implications

The hawkish signal from the BoE boosted sterling and government bond yields. In the immediate aftermath sterling had appreciated by around 1% against both the dollar and the euro. The 2-year and 10-year government bond yields also rose. There was little impact on UK stocks relative to other international bourses.

As the market digests these signals it is possible that the Bank is interpreted as less willing to look through elevated inflation. This could be perceived as troubling for the domestic economy, which may in turn impact domestically focused stocks.

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