Market Bulletin

3 August 2017

The Bank of England votes to keep rates on hold... for now

In brief

- The Bank of England (BoE) voted 6-2 in favour of keeping interest rates on hold at 0.25%, but indicated that rates may have to rise faster than the two rate rises the market had been anticipating over the next three years.
- The BoE slightly revised down its forecast for UK growth for both this year and next to 1.7% for 2017 and 1.6% for 2018.
- Inflation is expected to peak at 3% later this year and then fall over the next couple of years to 2.2% in 2019, reducing the current squeeze on real household incomes.

BoE Governor Mark Carney noted that households have cut back on spending as a result of a squeeze on real incomes from higher inflation, and that the Bank expects GDP growth to remain sluggish in the near term. However, he noted that the sole reason for inflation being above target is the fall in sterling caused by the Brexit referendum result. Over time, the year-on-year effect of that fall in sterling should dissipate, causing inflation to fall and reducing the drag on real incomes in the process. A modest improvement in net exports and business investment is also expected. Over the next three years, the spare capacity in the economy is expected to be fully absorbed due to weak growth in the supply potential of the economy.

The governor emphasised that the key driver of the outlook for the UK economy will be the uncertain outcome of the Brexit negotiations and that the current assumption of a smooth transition to a new economic relationship with the EU will be tested.

Investment implications

The pound fell in reaction to the 6-2 vote against a rate rise and the downgrade in near-term growth forecasts, despite the BoE being more hawkish on the medium-term outlook for rate rises. Government bond yields also fell with the market incredulous of the governor's warning that rates might have to rise faster than the pace that had been priced in to the yield curve prior to the meeting. In a familiar pattern for investors, the fall in the pound drove a rally in the FTSE 100, thanks to the large proportion of foreign revenues in the UK large-cap index. As Carney emphasised, the outlook for the UK economy and markets is highly dependent on the uncertain outcome of the Brexit negotiations. Given this uncertainty, we think investors would be well served by targeting a relatively low tracking error within the UK part of their investment portfolios.

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