Market Bulletin

May 10, 2018

UK Bank of England meeting: Rates on hold amid mixed signals on the economy

In brief

- The Bank of England (BoE) held its base rate of interest unchanged at 0.5% at its meeting today.
- Progress on the Brexit negotiations in the Autumn could see a swifter pace of interest rate normalisation in 2019.

The vote to keep interest rates unchanged at today's meeting was not unanimous; two members of the nine-strong Committee wanted to raise rates today but the remaining seven voted for rates unchanged.

Just a few weeks ago, we—and the market—had been expecting a 25 basis point increase in the Bank Rate at this meeting. But a string of disappointing data in recent weeks has thrown the Monetary Policy Committee off this course. Although the labour market still looks incredibly strong, with unemployment at multi-decade lows and wage growth picking up, 1Q GDP was weak—growing just 0.1% over the quarter. Data on consumer lending, retail spending and the housing market have also been soft.

The Governor indicated in the press conference that the BoE's assessment is that much of this weakness is temporary and can be attributed to the weather. It expects some rebound in 2Q with quarterly growth of 0.4%. Nevertheless this weakness early in the year does reduce their estimate of GDP growth over the year as a whole to 1.4%. Other revisions, to growth and inflation were modest (see **Exhibit 1**).

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EXHIBIT 1: 2018 growth nudged down but otherwise forecasts largely unchanged

	GDP (y/y)			CPI inflation (y/y)		
Meeting	2018	2019	2020	2018	2019	2020
Feb-18	1.8%	1.8%	1.8%	2.4%	2.2%	2.1%
May-18	1.4%	1.7%	1.7%	2.2%	2.1%	2.0%
Change	-0.4%	-0.1%	-0.1%	-0.2%	-0.1%	-0.1%

Source: Bank of England, J.P. Morgan Asset Management. y/y is year over year. Data are as of May 10, 2018.

As a result, holding rates constant this month should be interpreted as a minor diversion in the path of normalisation rather than an entirely new route. The BoE still expects to tighten policy in the coming year, though when depends on the evolution of the data.

On top of the mixed signals in the data, the BoE are having to contend with the uncertainty created by Brexit. The negotiations are likely to remain contentious in the near-term, both within the UK political sphere and between the UK and EU. Our best guess is that—by the autumn—the broad terms of the final partnership will be agreed. And the deal will include the free flow of both goods and services (for full details please see our Quarterly Perspective on ‘How will the Brexit negotiations affect European markets?’). If that is the case, the outlook for the UK economy could improve significantly going in to 2019. Our assessment is that there is still a sizeable ‘Brexit premium’ in UK markets. A constructive final deal would likely see a broad-based rise in sterling. This could result in a rapid fall in headline inflation at a time when wage growth is picking up. This would be a significant tailwind for the consumer. The resolution of uncertainty could also see a robust pickup in business investment.

In light of the current uncertainty, the Bank is, understandably, inclined towards a more hesitant rather than pre-emptive approach to normalising policy. But ultimately it still believes that “an ongoing tightening of monetary policy over the forecast period would be appropriate to return inflation sustainably to its target at a conventional horizon.” To meet its inflation target the BoE believe a very modest amount of tightening is required—just three 25 basis point hikes over three years.

Over this three-year horizon, we think it is likely that rates will rise by more. We expect the recent weakness in the data to largely prove temporary and a Brexit deal to be sketched out by October. If potential growth really is just 1.5% and the economy is already at full employment—as the BoE believe—then a pickup in growth next year should precipitate a faster pace of normalisation. We expect the BoE to raise rates by 25 basis points in November of this year, and if the global backdrop is similarly robust going in to 2019 then, much like the U.S. Federal Reserve, the BoE could settle in to a more significant pace of normalisation next year.

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