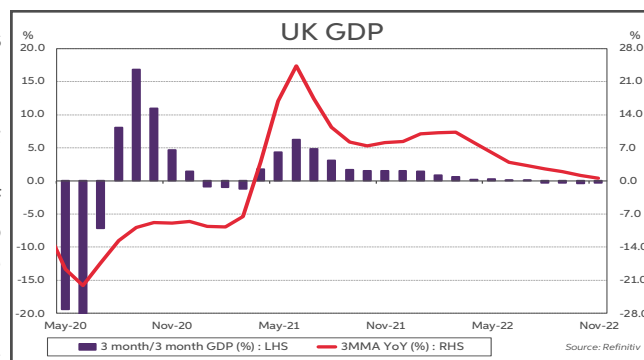


BoE hikes again by 50bps, but rates nearing the peak

The Bank of England's first Monetary Policy Committee (MPC) policy setting meeting of 2023 saw the central bank announce a 50bps rate hike. This follows a similar move in December. Today's rate hike brings the Bank rate up to 4.0%, and was in line with market expectations. It marks the tenth consecutive meeting where the BoE has raised rates. The BoE has now hiked rates by a total of 390bps since it commenced its current tightening cycle in December of 2021.

The voting breakdown showed that the MPC was split on its rate decision. Seven members were in favour of the 50bps hike. They were of the view that while headline CPI inflation had begun to edge back, the labour market remained very tight. At the same time, domestic price and wage pressures had been stronger than expected in recent months, suggesting risks of greater persistence in underlying inflation. Meanwhile, two members preferred to keep rates unchanged at 3.5%, on the basis that the real economy remained weak, and on continuing signs that the downturn was impacting the labour market, suggesting to them, that the current level of rates would likely reduce inflation to well below target over the medium term. These two members were also of the view that the rate policy setting was now increasingly restrictive, which would bring forward the timing of rate cuts.

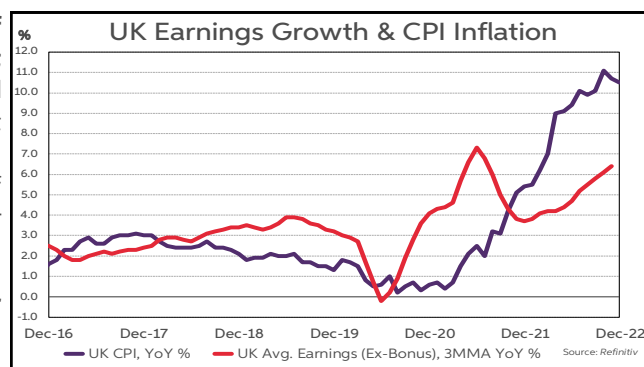


Today also saw the release of the February Monetary Policy Report (MPR) which contains a detailed assessment of the BoE's view of the economic outlook. For this year, the BoE has upgraded its growth forecast for the UK economy. It is now expecting a contraction of -0.5%, compared to its previous forecast for a -1.5% decline. It also anticipates that the rate of contraction in 2024 will not be as severe as outlined in the November MPR. It is now pencilling a modest 0.25% fall in GDP (was -1.0%). Further out, the BoE is expecting very muted growth of just 0.25% in 2025 (from 0.5%). Overall, the BoE now expects a "much shallower" recession, which it outlined in part reflected a more upbeat assessment of the outlook for consumer spending against the backdrop of recent strength in the jobs market, as well as, the fall in wholesale energy prices. Market interest rates are also lower than those that underpinned its November projections.

On the inflation front, Governor Bailey commented that the BoE has seen the "first signs that inflation had turned the corner ... but it is too soon to declare a victory just yet". The meeting statement noted that near term developments will be important in determining how quickly and to what extent external and domestic inflationary pressures will ease. The central bank expects inflation to fall back sharply from its current elevated level (10.5% in December) due, in large part, to last year's significant increase in energy and other goods prices falling out of the calculation of the annual rate. It is expecting inflation to slow towards 4% around the end of this year. The BoE anticipates that, on the back of more slack in the economy combined with declining external price pressures, inflation will fall to below the 2% target over the medium term. However, it emphasised that the risks to this inflation outlook are "skewed significantly to the upside". Indeed, Governor Bailey stated the upside risks to the BoE's inflation forecasts are greater than at any other time.

While the BoE retains a willingness to hike rates further if required, this hawkish bias is not as strong as it was at its last meeting in December. It has removed the phrase "respond forcefully as necessary" to inflation. The MPC stated today that it would continue to monitor indicators of inflationary pressures, especially in relation to wage growth and service inflation, and if they saw evidence of "more persistent pressures" then further policy tightening "would be required".

In terms of market expectations, futures contracts have another 25bps fully priced in for the next BoE meeting on March 23rd. This would see the Bank Rate rising to 4.25%. The market is currently pricing the peak in UK rates in and around this level. Prior to today's meeting, the market had a stronger conviction that the peak would be 4.5%.

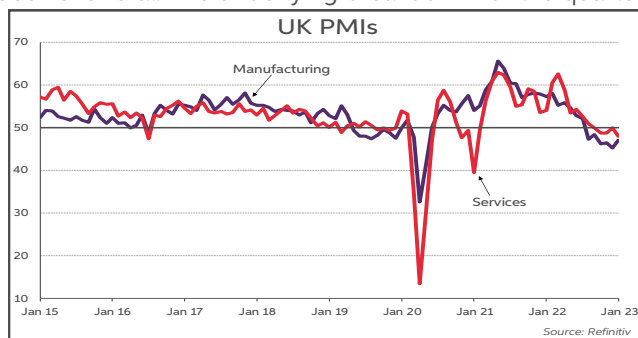


UK economy set to enter recession

Having expanded throughout H1 2022, UK GDP contracted by 0.3% in Q3. However, the Q3 figure was negatively affected by a Bank Holiday to mark the Queen's funeral. The underlying breakdown for the quarter showed that household spending fell by 1.1%, subtracting 0.7 percentage points (p.p.) from growth. Government expenditure and investment added, 0.1 p.p. and 0.2 p.p. to GDP. Net trade rose sharply, boosting output, but this was more than offset by changes in the inventories and valuables components. Overall, the UK GDP is estimated to be 0.8% below its pre-COVID level in the third quarter.

The most recent hard data remained soft, but suggest economic growth was not as weak in Q4.

The monthly reading of GDP for October shows the economy grew by 0.5%, although, this was largely due to the unwinding of the impact of the Queen's funeral. GDP rose by 0.1% in November also. Meanwhile, industrial production, which has yet to regain its pre-Covid level, fell by 0.2% in November. Elsewhere, retail sales fell by a substantial 1% in December, having declined in nine of the previous eleven months.



The limited available data for January indicate the economy continued to struggle at the start of 2023. Both the manufacturing and the services PMIs remained in contraction territory in January, with the latter deteriorating to 48.0, its lowest level since the start of 2021. Consumer confidence is very weak also, having fallen very sharply in 2022. The index fell to -45 in January, near its all-time low of -49 from last September.

However, conditions in the labour market remain very tight. The unemployment rate was unchanged at 3.7% in the three months to November. The jobs market remains tight as the fall in participation during the recent economic shocks has not reversed. There are roughly 200K fewer people in employment, and 386k fewer in the labour force than before the pandemic struck. The smaller pool of workers is placing continued upward pressure on wages, with average earnings growth accelerating to 6.4% y/y in the three months to November. The latest BoE Agent's pay survey shows that companies expect pay settlements this year to be just below 6% on average, broadly similar to wage deals made in 2022.

In terms of inflation, headline CPI edged lower to 10.5% in December, down from 10.7% in November, and a peak of 11.1% in October. The core CPI rate remained unchanged at 6.3% in December, just below its peak of 6.5% recorded in September and October. Although the Energy Price Guarantee (EPG) and other government supports to cap household energy bills are due to expire in April, a recent fall in wholesale energy and commodity prices suggests inflation may have peaked in the UK. The BoE still expects inflation will remain elevated in H1, but it should fall to around 4% in Q4 2023. However, the BoE notes the risks to its inflation forecasts are "skewed significantly to the upside".

Overall, the UK economy is facing a number of significant headwinds. The cost-of-living squeeze, due to higher inflation is weighing heavily on real incomes. Tighter monetary policy is also having a dampening effect on activity. However, the EPG has helped to cushion the blow to household finances in the near-term. Nevertheless, the BoE estimates real post-tax household income will fall by 0.5% this year. Meanwhile, UK exports are continuing to struggle from the double-hit of the pandemic and Brexit, which has resulted in a widening balance of payments deficit. Fiscal policy is also set to be tightened significantly over the next number of years, which will act as an additional headwind to growth.



The BoE is forecasting the UK economy will enter a protracted recession this year, with output falling throughout 2023 and into Q1 2024. However, the updated projections are for a much shallower recession than in the November update, with GDP declining by 0.5%, compared to 1.5%, previously. **The IMF also foresees a recession in the UK this year, with the economy contracting by 0.6%.** Longer-term, the UK economy faces a number of challenges, including its low productivity growth rate. The BoE sees the economy contracting by 0.25% again in 2024, and growing by just 0.25% in 2025.

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