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BoE near peak UK rates

Investment event | 22 September 2023

Is the Bank of England tightening cycle over?

The Bank of England (BoE) left rates unchanged at 5.25% at its September meeting, the first meeting it has not hiked since November 2021. The Monetary Policy Committee (MPC) also voted to increase the pace at which it would reduce the Bank's holdings of gilts to GBP 100bn over the next 12 months, from GBP 80bn over the last 12 months.

The expectation amongst forecasters was for a 25bp increase, although these predictions were made prior to the better-than-expected August CPI data, released the day before the Monetary Policy Committee (MPC) meeting. The decision was a close call, with a 5-4 split on the MPC between those favouring "no change" and those calling for a 25bp increase.

MPC members calling for no change in the policy rate cited "signs of loosening in the labour market" and the downside surprise in services inflation in the August CPI data. Although average weekly earnings had been higher than expected, this group highlighted that other indicators of pay growth showed greater signs of moderation. One member was concerned that the "risks of overtightening had continued to build".

Against this, dissenting members favouring a 25bp rate hike noted:

- Real household income "had started to rise";
- Forward-looking indicators of output "had remained positive"; and
- The labour market remains tight, with measures of wages and services inflation "above those consistent with meeting the 2% medium-term inflation target".

Overall, however, members of this group acknowledged the decision was "finely balanced".

Mixed labour market data

The Bank of England has cited three key metrics for setting monetary policy: services inflation, private sector wage growth and the vacancy to unemployment rate. On these metrics, the latest data reveal two promising signals:

- The labour market appears to be softening, with the unemployment rate increasing by 0.8pp from its trough to 4.3% in the three months to July.
- Service sector inflation was weaker than expected in August, at 6.8%yoy. However, some of the weakness looks to have been driven by erratic factors, such as air fares, so could reverse in the coming months.

Against these tentative signs of receding inflation pressures, wage growth remains exceptionally high – underlying private sector average weekly earnings increased 8.1% yoy in the three months to July, well above the BoE's forecast made only one month ago. However, it appears that a majority of MPC members are putting an emphasis on labour market surveys showing easing pay pressures, rather than focussing on the official wage data.

The policy outlook

The September policy decision suggests an increasing number of committee members are reluctant to raise rates further, for fear over overtightening and pushing the UK into a deeper-than-necessary downturn. Indeed, the MPC revised down its forecast for Q2 2023 GDP to 0.1% q/q, from 0.4%, acknowledging growth in H2 2023 will be weaker than expected.

While we judge it likely that the MPC has delivered its last hike of the cycle, a 25bp rate hike in November cannot be ruled out; further upside surprises in the official wage growth data or a rebound in service-sector inflation could force the Bank's hand, even if it reluctant to do more.

Looking further out, the market is pricing the Bank rate to remain largely unchanged through much of 2024. However, we see downside risks to this view later in the year. Policy tightening has been slow to feed through to the economy, which means the bulk of the impact is likely to be felt in 2024. We expect this to push the UK into a recession. Initially, persistent inflation pressures are likely to limit the MPC's ability to ease policy, but during H2 2024 we see the potential for rate cuts.

Investment implications

The lagged impact of tighter monetary policy on the real economy warrants caution on the outlook for the UK macro cycle. The ongoing risk of recession across major developed markets points to a challenging environment for global equities over the next 12 months. We continue to advocate a cautious asset allocation, which includes an underweight view on UK equities. More generally, we favour a defensive asset allocation at present and see value in many parts of high-quality short-duration global fixed income.

The BoE left its policy rate unchanged 5.25% in a finely balanced decision

The BoE is increasingly concerned about the risk of overtightening policy. However, inflation and wage pressures remain elevated

Our view:

We continue to advocate a cautious asset allocation, which includes an underweight view on UK equities

We are neutral on short-dated gilts but see value in the 10yr sector.

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I 1887 exp 31/03/24