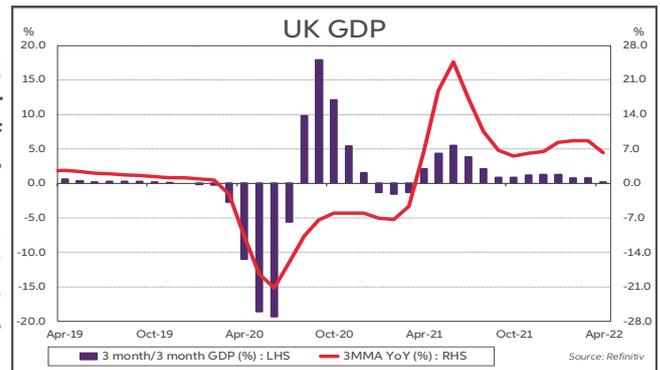


BoE hikes by 25bps and turns somewhat more hawkish

The June meeting of the Bank of England’s Monetary Policy Committee (MPC) saw the announcement of a further tightening of policy. The MPC increased the Bank Rate by 25bps to 1.25% in light of the continuing “signs of robust cost and price pressures and the risk that these become more persistent”. This is the fifth meeting in-a-row where the BoE has hiked rates. It commenced its tightening cycle last December with a 15bps rate hike. This was followed by 25bps increases at its February, March and May meetings.

Today’s policy decision was in line with market expectations. All 9 MPC members were in favour of a rate hike. **However, similar to May there was a difference of opinion over the magnitude of the increase.** The voting breakdown showed the Committee voting 6:3 in favour of the decision to raise rates by 25bps, with the same three members from the May meeting preferring a 50bps rate hike in June. The three members were of the view that a faster pace of tightening was warranted in order to reduce the risks of a “more extended and costly tightening cycle later”.

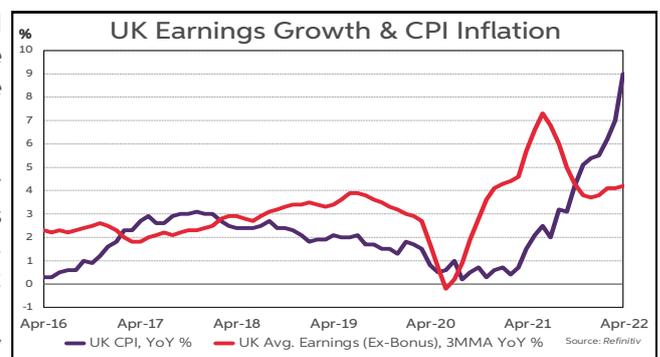


At its previous meeting in May, the BoE provided a detailed assessment of its view of the inflationary and economic outlook in its Monetary Policy Report (MPR). It noted in today’s statement that growth was weaker in both Q1 and April than it had factored into its assessment in May. Overall though, it stated that incoming macro data did not suggest a materially different near-term underlying growth path to the one that was envisaged in May. The May MPR, showed that the BoE expects a major slowdown in the UK economy. It anticipates that after growth of 3.75% in 2022, GDP will contract by 0.25% in 2023. For 2024, it is projecting very modest growth of just 0.25%. **This constitutes a mild recession followed by a period of stagnation over the next two years.**

Meanwhile on the inflation front, it commented today that the most recent data, which showed the headline CPI rate rising to 9% in April, was broadly in line with what was factored into its calculations contained in the May MPR. **However, the June statement/minutes did reference that it has once again revised higher its expectation around where inflation will peak this year.** It now anticipates inflation rising to slightly above 11% in October compared to its previous projection of slightly over 10% at its peak in Q4. This was mainly due to larger increases in energy/utility prices. Further out, it envisages inflation remaining above its 2% target in Q4 2023, at 3.5%, but expects it to fall to 1.5% by the end of 2024. It stated today that risks to its inflation projections remained “skewed to the upside”.

A significant development at the May MPC meeting was the disagreement in relation to forward guidance it provided on rates. Some members were of the view that it was no longer appropriate for the BoE to guide that further policy tightening might be needed. **In this month’s update though, the guidance provided on the rate outlook was less specific, but had a more hawkish leaning. The BoE now states that it will be particularly alert to persistent inflationary pressures and “would if necessary act forcefully in response”.**

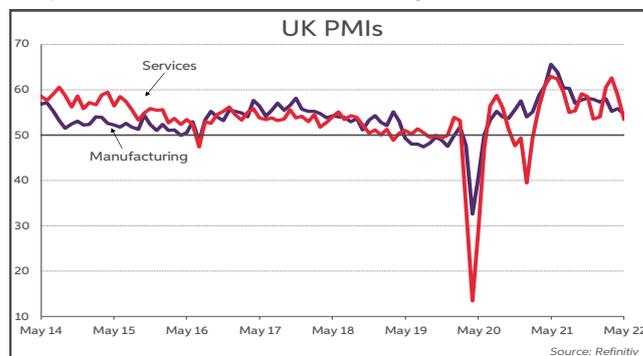
In terms of market expectations, similar to the moves in US and Eurozone markets, futures contracts are now pricing in a more aggressive pace of rate hikes. The market sees the Bank rate ending this year at 3% compared to 2.1% after the May meeting. It sees rates peaking at close to 3.4% in the first quarter of 2023, which is around 100bps higher than in the aftermath of the May meeting. There was some volatility for sterling following today’s BoE meeting. The currency initially weakened. However, this was short-lived. Sterling has moved up above the \$1.22 threshold versus the dollar, while EUR/GBP is back below 86p. Meanwhile, the policy sensitive 2-year Gilt yield has risen by around 20bps to above 2.2%.



UK economy stagnates as inflation bites

UK GDP rose by 0.8% in Q1, as COVID restrictions were eased at the start of the year. However, the growth was concentrated at the beginning of the quarter. Monthly data show output rose by 0.7% in January and stagnated in February, before contracting by 0.1% in March. The underlying breakdown showed that consumption rose by 0.4% in the quarter. Fixed investment accelerated sharply, rising by 5.4%. However, government expenditure fell by 1.7% as pandemic related spending declined. Meanwhile, exports fell by 4.9% in Q1, while imports rose by 9.3% as firms rebuilt stockpiles. As a result, net trade weighed on GDP in the opening three months of the year.

Data for Q2 indicate economic activity remained muted at the start of the quarter. The April reading of GDP showed output contracted by 0.3% in the month, as the rebound in private sector activity was more than offset by a further decline in pandemic related health spending. Without the fall in pandemic related expenditure, GDP would have been +0.2%. Retail sales excluding fuel jumped by 1.4% in April, having declined in four of the five months previous. Industrial output though, continued to deteriorate. Production fell for the third month running in April, down by 0.6%. Manufacturing and construction output also fell sharply in April, by 1% and 0.4%, respectively.



Meanwhile, survey data have weakened so far in Q2. The manufacturing PMI declined to its lowest level since January 2021 in May, at 54.6, suggesting that the recovery in the sector is slowing. Elsewhere, the services PMI fell sharply from 58.9 to 53.4 in May as business confidence continued to wane due to higher costs and concerns regarding the economic outlook. Consumer confidence is very weak also. It has fallen every month since the start of the war in Ukraine, and is now at an all-time low of -40, as the cost of living squeeze continues to place downward pressure on real household disposable incomes. In this regard, the UK government announced a support package worth circa £15bn to try and alleviate some of the pressure on household incomes due to the increased cost of living.

In terms inflation, headline CPI jumped to 9% y/y in April, its highest level since 1981. The core CPI rate rose to 6.2% from 5.7%. Inflation is set to spike higher again in Q4, as Ofgem is expected to sanction a further increase in the energy price cap in October. Furthermore, the ongoing war in Ukraine continues to place upward pressure on energy and commodity prices. The BoE now sees inflation rising to above 11% in October.

Labour market conditions remain very tight. The official jobless rate stood at 3.8% in the three months to April, the same rate as just before the pandemic began in early 2020. However, the rate spiked higher to 4.2% in April itself. There are now roughly 366k fewer people in employment than before the pandemic struck. The smaller pool of workers appears to be placing upward pressure on wages. Average earnings, excluding bonuses, were up 4.2% y/y in April. Businesses responding to the BoE's Agents Survey earlier this year noted they expect pay settlements to be much higher, at 4-6% this year compared to 2.5-3.5% in 2021.



Overall, the UK economy is facing a number of headwinds. The cost-of-living squeeze, due to an increase in taxes and higher inflation, is being accentuated by the war in Ukraine, which is driving inflation even higher. As a result, the OBR estimates real household disposable incomes will drop by 2.2% this fiscal year, the biggest fall since records began in the 1950's. Conditions in the labour market are very tight also, increasing the risks of second-round inflation effects, resulting in the need for more aggressive increases in interest rates. Despite the recent government support package, fiscal policy is set to be less supportive this year also. Meanwhile, UK exports are continuing to struggle from the double-hit of the pandemic and Brexit, while tensions with the EU regarding the NI Protocol have flared up once again recently. **The latest OECD forecasts for UK GDP have been revised lower to 3.6% for this year and 0% in 2023, close to the BoE projections.**

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