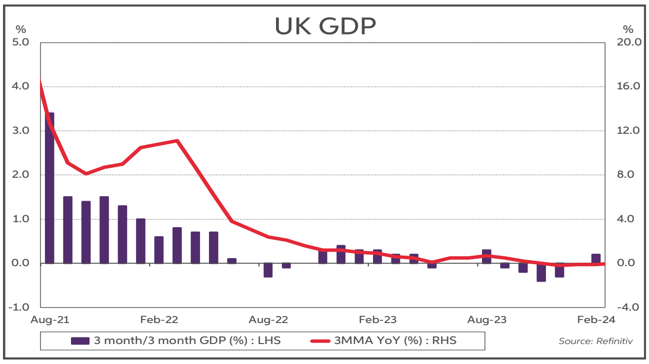
BoE Watch

AIB Treasury Economic Research Unit

9th May 2024

BoE opens door to possible rate cut in June

The May meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank keep its key interest rate unchanged at 5.25%. This outcome was very much in line with market expectations. It marked the sixth consecutive meeting where the BoE has remained on hold.

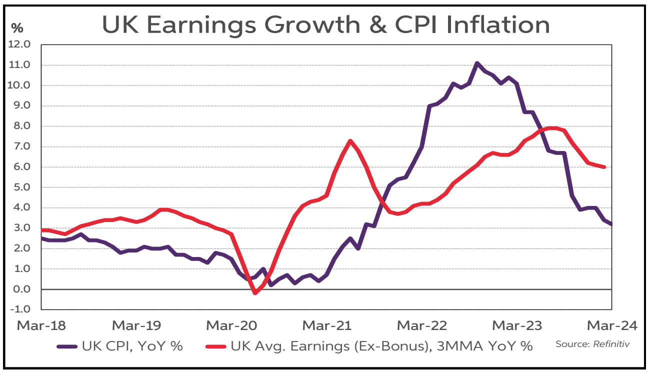


Once again, the voting breakdown today showed the MPC remained split on its rate decision. The vote split is now 7:2 in favour of no change. This represented a dovish shift, with two MPC members (Dhingra and Ramsden) now voting for a rate cut compared to just one (Dhingra), at its previous meeting in March. For these two, they judged that now was the appropriate time for the BoE's interest rate setting to become less restrictive to "enable a smooth and gradual transition in the policy stance". For the majority of MPC members they acknowledged that inflation is easing and inflation persistence was moderating. However, there were a range of views amongst the 'seven' on (1) risks on the assumptions regarding inflation persistence and (2) the extent that forthcoming data would lead them to update their assessment of inflation persistence.

The BoE's latest set of detailed macro forecasts were also released today, with the publication of its quarterly Monetary Policy Report (MPR). In terms of its growth outlook, the BoE continues to project a prolonged period of very weak activity in the UK economy, although compared to its February forecasts, it has revised slightly higher its GDP projections. GDP growth is forecast at 0.5% this year (was 0.25%), then picking up modestly to 1.0% in 2025 (was 0.75%) and rising to 1.25% in 2026 (from 1.0%). The BoE commented that it expects the recovery in output to be "underpinned by a pick-up in household consumption, supported by higher real incomes". **On the inflation front, the May MPR projections show that the BoE anticipate the CPI rate will fall temporarily to 2% in the near term, but to rise slightly in the second half of this year, to around 2.5%.** The BoE attributes the modest acceleration in inflation to the unwinding of energy related base effects. Further out, it has revised slightly lower its inflation projections. It is now projecting that inflation will decline to 2.25% (was 2.5%) by the end of next year. Meantime, it is pencilling in an inflation rate of 1.5% (was 2.0%) by end-2026. The MPC noted today that in the near term there continued to be "upside risks" to its inflation outlook, arising from geopolitical factor but it also stated that the "risks overall were more evenly balanced over the second half" of its forecast horizon.

Assessing the various outputs (statement, minutes, forecasts, press conference) from the BoE today, there is a definite easing bias within the central bank. The meeting statement and minutes noted that the restrictive stance of monetary policy is weighing on the real economy and in turn, is "bearing down on inflationary pressures". The statement also outlined that the MPC will consider incoming data to determine if the "risks from inflation persistence are receding" which will help it determine "how long Bank Rate should be maintained at its current level". As referenced above, the MPC revised lower its inflation projections over the forecast horizon.

Meanwhile, more explicitly, Governor Bailey's comments during the press conference suggest that the June MPC is now very much a 'live' meeting from a rate cut perspective. He emphasised that by the time of its next meeting on June 20th, the BoE would have "two full sets" of data to inform its policy decision. He noted that there would likely be a need for rate cuts over the coming quarters and that these could be to a greater degree than currently priced into market rates. Governor Bailey also commented that "one cut" to interest rates would "still leave us with restrictive monetary policy".



Following today's meeting, futures contracts pricing indicate that the market continues to put a higher probability on the first rate cut occurring in August rather than June. The market is anticipating around 50bps of rate cuts by year end. **However, taking on board Governor Bailey's comments during the press conference, the market may be underestimating the potential for a rate cut as soon as June.** If this does materialise, the market assumption of just 50bps of cuts in total for this year, may also have to be reassessed, with 75bps being a more reasonable expectation in our view.

David McNamara Chief Economist david.g.mcnamara@aib.ie	John Fahey Senior Economist john.j.fahey@aib.ie	Daniel Noonan Economist daniel.x.noonan@aib.ie

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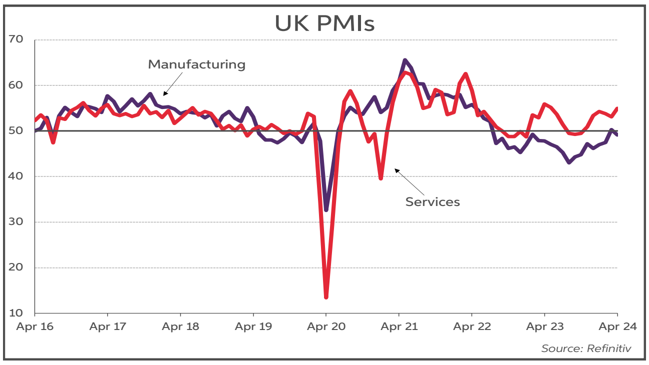
UK economic outlook remains challenging

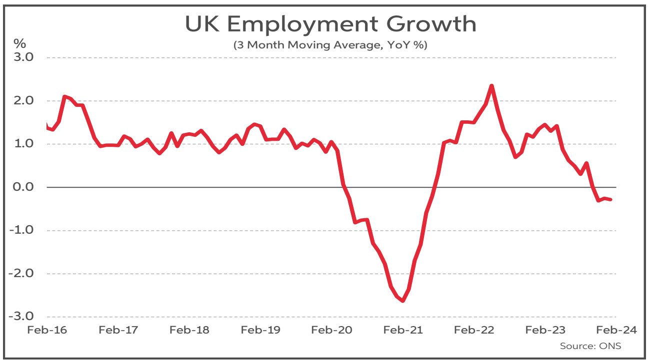


The UK economy performed better than anticipated in 2023, as it avoided the deep recession that had been widely predicted. However, revisions to the data show the economy performed rather poorly overall. Having expanded by 0.1% in Q1 and by 0.2% in Q2, GDP growth stagnated in Q3, before contracting by 0.3% in Q4. It means that for the full year, the economy was just 0.1% larger than in 2022.

However, the most recent hard data suggest the economy returned to growth in the first quarter of 2024. After declining by 0.1% in December, the monthly reading of GDP for January registered a 0.3% increase. This was followed by a 0.1% rise in February also. Meantime, retail sales rebounded sharply by 3.7% in January, recovering from a hefty 3.2% fall at the end of last year. However, retail activity was rather stagnant throughout the remainder of the quarter, increasing by 0.1% in February before flat-lining in March. In contrast, industrial production fell by 0.3% in January, but rebounded by 1.1% in February. Overall, industrial output was up by 1.4% in year-on-year terms in February.

Survey data also indicate the economy regained some momentum at the start of this year. The services PMI rose to its highest level since May 2023 in January, and was little changed throughout the remainder of the quarter. Meantime, the manufacturing PMI has also improved in Q1. It rose to 50.3 in March, moving into expansion mode for the first time since July 2022. Overall, the former averaged 53.7 in the quarter (compared to 51.3 in Q4), while the latter rose to 48.3 on average (compared to 46.1). Elsewhere, consumer confidence rose to –19.0 in January, its highest level since the start of 2022, before edging slightly lower to –21.0 in February and March. **The limited available data for April show that consumer confidence improved to –19.0 in the month, while the services PMI jumped to 55.0, although the manufacturing reading fell back to 49.1.**

In terms of the labour market, conditions remain tight but there have been some signs of softening in recent months. The unemployment rate has increased steadily to 4.2% in February from 3.8% in December. Furthermore, the number of people in employment has fallen by over 190k since November. At the same time, average earnings growth remains elevated at +5.6% y/y in the three months to February, albeit this is well below its recent peak of 8.5% last July. However, the MPC has noted that other measures of wage inflation continue to point to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q1, showed most respondents reported lower pay settlements this year than in 2023, and that cost of living payments are not expected to be made this year.



Meantime, inflation is in decline. Headline CPI inflation fell to 3.2% in March from 4.0% at the start of the year. Core-CPI inflation which had been proving to be quite sticky, dropped to 4.2% in March, from 5.1% in December. However, services inflation remains very high, running at 6.0% in February and March. The BoE sees headline inflation at 2.5% in Q4 2024, easing to 2.25% and 1.5% by end-25 and end-26, respectively.

Overall, having performed poorly in 2023, particularly in the second half of the year, the UK economy appears to have registered some improvement at the start of 2024. Furthermore, inflation is in decline, and is expected to fall further this year, paving the way for real income growth and interest rate cuts in the second half of 2024. Both factors should help underpin a rebound in consumption this year.

However, the outlook for UK growth remains subdued. The OECD is forecasting the UK economy will register the second slowest growth rate in the G7 this year, with GDP rising by just 0.4%. Growth is expected to accelerate to around 1.0% in 2025. Meanwhile, the BoE sees the economy growing by a 0.5% in 2024 and by 1.0% in 2025.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit