HSBC

Asset Management

BoE reverts to 25bp rate hike

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Bank of England slows the pace of hiking

The Bank of England (BoE) raised interest rates by 25 basis points (bp) to 5.25% at its August meeting. This move signals a return to the modest pace of tightening seen prior to the June meeting, when the BoE hiked interest rates by 50bp.

In justifying its August rate hike, the BoE cited significant upside surprises to wage growth, suggesting some of the "risks of greater persistence in broader domestic inflationary pressures had crystallised". For the first time, the MPC acknowledged current monetary policy was restrictive, but reiterated that it could hike again if "there is evidence of more persistent price pressures".

The decision by the Monetary Policy Committee (MPC) saw a 3-way split. Overall, the MPC voted 6-3 in favour of a 25bp rate increase. Two MPC members, Haskell and Mann, favoured a 50bp rate increase to "lean against" persistent inflation. One member, Dinghra, called for no policy change, due to the risk of overtightening monetary policy and the sizeable lagged impact of previous monetary policy tightening that has yet to be felt. At her first MPC meeting, Megan Greene voted with the majority in favour of a 25bp rate hike.

Table 1: BoE Monetary Policy Committee projections

	2023	2024	2025
CPI inflation (%)	5	2½	1½
May 2023 BoE projection	5	2¼	1
GDP (%)	½	½	¼
May 2023 BoE projection	¼	¾	¾
LFS* unemployment rate (%)	4	4½	4¾
May 2023 BoE projection	3¾	4	4 ½
Excess supply/demand (%)	½	-¼	-1¼
May 2023 BoE projection	¼	- ½	-1

*Source: Bank of England, CPI and GDP forecasts refer to percentage change year-on-year. *Labour Force Survey.*

Labour market remains key

The BoE is now more confident about inflation slowing in the near-term than in May, but the medium-term outlook remains uncertain due to continued tight labour market conditions. Recently, there have been increased signs of cooling in the labour market, such as higher unemployment and a lower unemployment/vacancy rate, but wage pressures persist. In the three months to May, underlying private sector earnings grew by 7.7% yoy while on a three-month on three-month annualised basis, this measure of pay growth exceeded 9%.

The UK economy has suffered two supply side shocks: (1) weaker labour supply and (2) the previous gas price shock. In order to contain price pressures, the BoE needs to push demand back into better alignment with supply to ensure inflation reaches its 2% target over the medium-term.

The policy outlook

In the UK, wage growth, a key driver of service-sector inflation, continues to rise, unlike the US and eurozone. This suggests the peak in UK interest rates has not been reached. We expect further BoE tightening in coming months. Market pricing of a 5.75% terminal rate seems reasonable but would be challenged to the upside if wage growth fails to moderate.

Ongoing price pressures suggest the BoE will keep rates higher for longer to squeeze inflation out of the system. Consequently, we do not expect BoE to reverse some of its policy tightening until the second half of 2024, despite our view that the economy will lapse into a recession before then.

Investment implications

With monetary policy impacting the real economy with a significant lag, we remain cautious on the outlook for the UK macro cycle. Elevated recession risk creates a difficult environment for global stock markets over the rest of 2023. And we think a defensive asset allocation posture makes sense for now and see value in many parts of high-quality short-duration global fixed income.

The BoE hiked interest rates by 25bp to 5.25%

Ongoing concerns about persistent inflation pressures prompted the BoE's latest move

Our view:

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

Sterling is likely to trend higher as the dollar rally unwinds, but could face some resistance from risk-off sentiment

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

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