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BoE raises rates by 50bps

Investment event | 22 June 2023

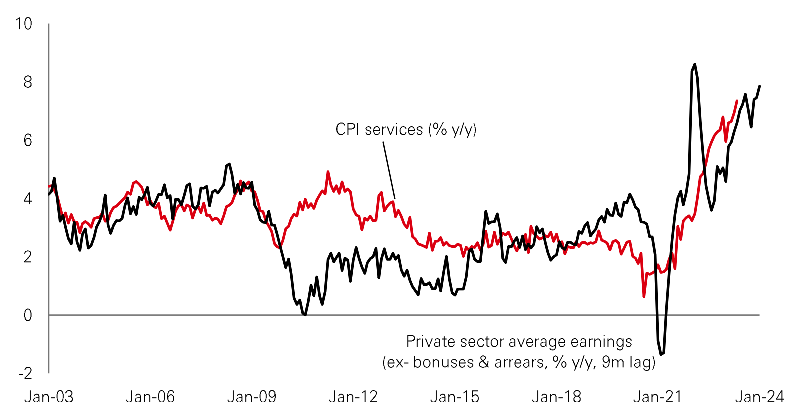
Bank of England ups the pace of hiking

The Bank of England (BoE) surprised markets at its June March meeting, raising Bank rate by 50 basis points (bps) to 5.00%. This latest move marks a departure from smaller 25bp rate increases in the last couple of meetings.

The BoE cited the scale of recent upside surprises in wages and service sector inflation and "more persistence in the pricing process" as the main factors behind the BoE's more aggressive posture. The latest statement reiterated that further policy action would be implemented if inflation pressures persist but did not signal a pre-commitment to a particular course.

The decision by the Monetary Policy Committee (MPC) was split. Overall, the MPC voted 7-2 in favour of a 50bp rate increase, with a minority calling for no change. The two dissenters reiterated that goods price disinflation would dampen wage pressures, whilst the lags of previous rate hikes are still to feed through the UK economy.

Figure 1: CPI services and wage growth running hot



Source: Macrobond, HSBC AM

How do they break the current wage-price ratcheting?

The BoE's main concern is the recent rise in both wages and inflation persists in the coming months, potentially de-anchoring of inflation expectations. In early 2023, the BoE expected lower headline inflation to exert significant downward pressure on wage growth, but this has clearly not materialised. Although some labour market indicators, such as vacancies, have continued to decline, the unemployment rate unexpectedly fell to 3.8% in the three months to April, signalling a very tight labour market. Indeed, underlying private sector regular earnings, closely monitored by the MPC, increased by 7.6% yoy in the three months to April. The print was 0.5pp above the BoE's May forecast.

The UK economy has suffered an acute supply-side shock from weaker labour supply and the previous gas price shock. The BoE needs to bring demand back into line with supply to contain price pressures. Although the lagged impact of previous policy tightening should feed through in the coming months, time is not on the BoE's side. Consequently, the BoE has decided to pursue a more aggressive stance, increasing the likelihood of a UK recession in 2024.

What is the outlook for the BoE?

In our view, the Fed and the ECB are close to the end of their current tightening cycles. However, the BoE needs to tighten monetary policy further to prevent inflation becoming embedded in the UK economy.

We expect further BoE tightening in coming months towards a peak of 5.75% by year-end, but with a risk Bank rate hits 6.00%.

In 2024, the BoE is likely to lag the US and euro area in cutting rates given more persistent inflation pressures. However, the UK is likely to enter a meaningful recession, opening the door to some policy easing later in the year.

The BoE hiked interest rates by 50bps to 5.00%

Rising concerns over persistent inflation pressures prompted the BoE's aggressive 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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Investment implications

We remain underweight **UK equities**. While stocks' high dividend yield feature is attractive, there are significant downside risks to earnings – especially when compared to other developed market equities. Moreover, we think a recession is needed in the UK to solve an intensified inflation problem.

On **sterling**, a protracted US dollar down-drift (which would see an appreciation in the pound) could further hurt large UK companies that earn a significant portion of their profits abroad. The June MPC decision does little to change this view.

However, on the flip side, sterling is a highly cyclical currency. This means it is vulnerable to a large global risk-off episode.

Within the **DM government bond space**, we are neutral 2-year UK gilts, given the market is already pricing in Bank rate rising to around 6.00%. However, we believe the high likelihood of a UK recession could support 10y gilts. More widely, we see value in many parts of global fixed income at this stage of the economic cycle.

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