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Special Coverage:

BoE holds, but balance of opinion shifts closer to August cut

Jonathan Sparks
Chief Investment Officer, UK, HSBC Global Private Banking and Wealth

Abhinav Pandey
Investment Strategist, HSBC Global Private Banking and Wealth

Key takeaways

- The Bank of England (BoE) voted by 7-2 to hold the bank rate at its current level of 5.25%. Even though this meeting was limited in communications ahead of the UK general election, the central bank gave enough hints to shift the markets closer to an August cut. However, the central bank remained cautious of the sticky services inflation, which only ticked down from 5.9% to 5.7% y-o-y. It also upgraded its projection for Q2 GDP growth to 0.5% from 0.2% in the May forecast. This will likely lead to some narrowing of the projected economic slack when they revise their forecast in August.
- This means that an August rate cut is finely balanced. The BoE's insistence that the current rates are restrictive and that labour markets are cooling should just be enough for a rate cut at the next meeting. Yet, the highly data-dependent BoE will pay very close attention to the path of services inflation and wage growth.
- We are neutral overall on UK equities as the FTSE 100 is too defensive for us, but our tilt towards more cyclicality and an improving UK outlook shines a light on the attractively valued FTSE 250. UK gilts remain an attractive investment. Rate expectations are broadly in line with our thinking, while the longer end of the gilt curve reflects a hawkish landing zone for UK policy rates. This tips the risks in favour of lower gilt rates. Moreover, we think the GBP will be driven more by policy rate differentials.

What happened?

- The BoE doesn't like to shock markets and voted by 7-2 to hold the bank rate at its current level of 5.25% at its June meeting. This was a meeting more for reading between the lines: would the BoE lay the ground for a cut in the August 1st meeting? There wasn't a huge amount to go on since the BoE is in a quiet period ahead of the election, but the comments that the committee was "finely balanced" on the decision to cut rates and that the latest data "didn't alter significantly the disinflationary trajectory that the economy was on."
- The BoE also saw further falls in the headline CPI to 2% as "good news". Additionally, the fact that internal policy committee member Dave Ramsden held his position for a cut further kept the prospect of an August cut alive.
- On the more hawkish side, the BoE conceded that Q2 GDP growth would likely be stronger than forecasted in May – it now expects Q2 growth of 0.5% instead of 0.2%. The BoE noted this would impact the balance of demand and supply in the economy. The central bank will update its forecasts at the August meeting, but it seems likely that it will forecast a reduced amount of economic slack due to stronger Q2 demand. This may translate to a higher inflation projection in August and can also explain current stickiness in services inflation.
- The impact of higher Q2 growth needs to be tempered by the BoE's observation that rates were restrictive, leading to a cooling labour market, and that trend quarterly growth was probably around 0.25%. This should limit the upward revisions to their medium-term forecasts. Also, there is some breathing space in these forecasts since the BoE's projections in May forecasted inflation falling below 2% in two years and to 1.6% in three years. Nevertheless, the August meeting will still be driven by data on domestic inflationary persistence.

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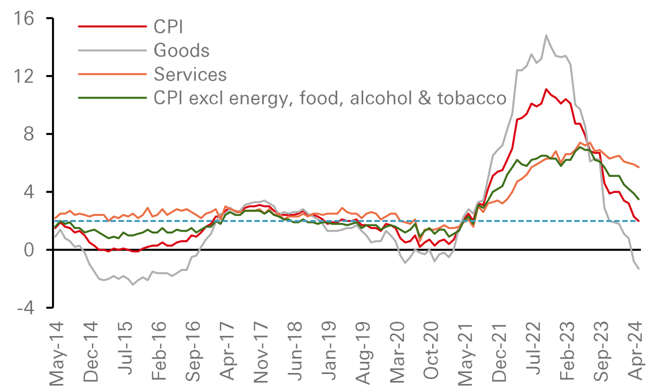
- The Monetary Policy Committee had highlighted previously that services inflation is the most important indicator that it looks at. The resilience in services inflation can be put down to accumulated savings and decent pay growth. Interestingly, regular pay growth in the private sector slowed to 5.8% over the same period, from 5.9% previously, but remains at elevated levels.
- The whole economy wages continue to recover and have picked up to an annualised 6.8%, which will slowly moderate further as this was attributed mainly to the National Living Wage rise. UK unemployment rose to its highest in more than 2 years at 4.4%, and even though the BoE is sceptical over the data quality, it does back up the broader picture of a cooling labour market – falling job vacancies is another example.

Services remain the trouble point



Source: ONS, HSBC Global Private Banking and Wealth, as at 20 June 2024. Past performance is not a reliable indicator of future performance.

- Considering most of the rate hikes have been absorbed by households, it's understandable that the housing market is seeing some support. The average price of a home rose to £281,000 (USD357,760), a 1.1% rise compared to a year ago. This followed a 0.9% gain in March, which was revised down from 1.9%. However, mortgage rates have ticked up again in recent weeks, and the BoE will likely see the housing market's stabilisation as fragile.
- This boils down to a pathway where the BoE dials down a restrictive monetary policy approach. We expect this as a cut in the next meeting in August. However, data in-between could lead to some twists and turns along the way. Although the BoE did not cut the rate, housing market will certainly cheer up the inflation drop for this month and will hope that this is first step towards lower mortgage rates in the second half of the year.

Investment implications

- Historically, elections have had little impact on GBP, which is more driven by the BoE's monetary policy outlook. The fact that betting odds and polls are strongly pointing to a Labour majority also means that a change in government is also being echoed by markets. While GBP isn't immune to policy changes, the nearer-term focus will still be concentrated on policy rate differentials.
- The outlook for equities is looking up. Although UK stocks have lagged their continental peers amid political instability after 2016 Brexit, the more domestically focused FTSE 250 stocks seem to be turning a corner. They tend to be more sensitive to UK economic data, and the uptick in economic momentum and attractive valuations are drawing investors in. Our projection of a more resilient GBP will also help, considering FTSE 250 companies are more reliant on imports – and demand from households, who are also importers. (Source: Bloomberg as at 20 June)
- The FTSE 100 has also found some renewed appeal thanks to its skew towards value. We should also not ignore that the UK market has seen a high number of M&A activity given its cheaper valuation. So far, in 2024, it has seen USD37 billion worth of public M&A deals targeting UK companies, which is above 68% from last year's data.
- Our overweight in gilts remains. The market has pushed down longer-term rate expectations more towards our forecasts. Markets have taken the resilience of the UK economy to higher rates and have extrapolated forward to a future where the interest rate cycle oscillates around 3.5%. This goes against the longer-term trend for lower rates. It may be the case that the post-financial crisis ultra-low-rate environment was temporary, but we see a meaningful risk that the market is putting too much emphasis on the post-covid environment. Therefore, the risks to rates are skewed to the downside, in our view. This opens up a clear opportunity to put cash to work in gilts, locking in these higher rates, especially now yields are trading at attractive levels – 2-yr, 10-yr & 30-yr gilt yields trade at 4.17%, 4.06% and 4.56%, respectively (as at 20 June).

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