THE U.K. ECONOMIC MONITOR

MAY 11, 2018
SAMUEL TOMBS, CHIEF U.K. ECONOMIST

The MPC's rhetoric hasn't changed; it still expects above-trend growth to lead to some excess demand.

It thinks three rate hikes are needed in the next three years—not two, as markets expect—for 2% inflation.

An August rate hike still looks likely, just; inflation looks set to exceed the MPC's forecast before then.

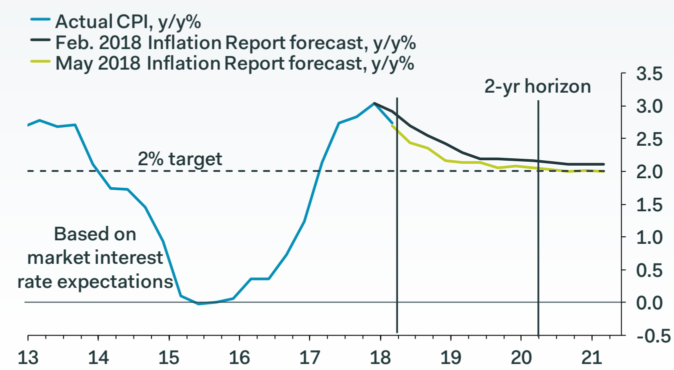
Markets Now Underestimate the MPC's Tightening Bias

The MPC emphasised yesterday that its faith that interest rates need to rise further has not been shaken by recent downside data surprises. The Committee reiterated that it still envisages an "ongoing tightening of monetary policy", though it has wisely refrained from explicitly signalling the timing of the next hike. ***On balance, we still think the odds of an August rate hike slightly exceed 50%, but it would not take much more sub-par activity data for the MPC to wait a little longer.***

The MPC is untroubled by the drop in quarter-on-quarter GDP growth, to just 0.1% in Q1, from 0.4% in Q4. It attributed the slowdown largely to the unusually bad weather and expects the preliminary estimate to be revised up to 0.3% in time. It also expects GDP growth to recover to 0.4% in Q2, and year-over-year growth to average 1.75% over the next three years, slightly exceeding the economy's diminished trend growth rate, 1.5%. As a result, the MPC still expects a "small margin of excess demand" to emerge by early 2020. The Governor concluded at the press conference that the "overall economic climate... looks little changed", and also noted that the labour market had remained "reassuringly strong".

On the face of it, the new CPI inflation forecast signals less urgency to hike rates. The MPC lowered its Q2 forecast to 2.43%, from 2.70% in February, and its two-year ahead projection to 2.03%, from 2.16%. *May 2015 was the last time the Committee expected two-year ahead inflation to hit the 2% target.*

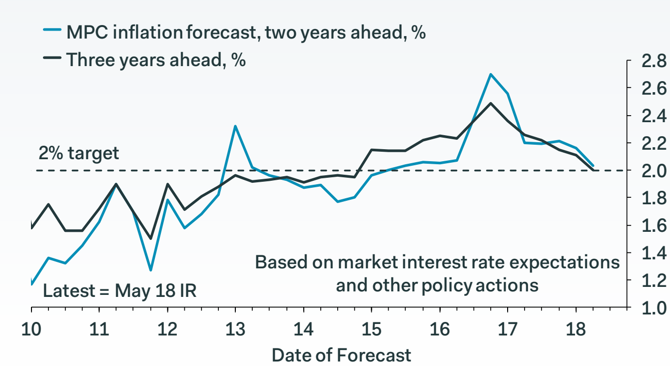
THE MPC REVISED DOWN ITS FORECAST FOR CPI INFLATION...



Crucially, however, both the growth and inflation projections are conditioned on markets' expectations for Bank Rate in the 15 working days to May 2, when three 25bp increases in Bank Rate were priced-in over the next three years. That's slightly more tightening than anticipated in February, and one more 25bp hike than markets' expect now.

The MPC also made the case for further tightening with its alternative forecasts, which assume that Bank Rate remains on hold throughout the next three years. On this basis, it thinks that year-over-year GDP growth would average 1.9% and CPI inflation would settle at 2.4%, clearly breaching the MPC's mandate.

...ITS TWO-YEAR AHEAD PROJECTION IS THE LOWEST SINCE MAY 2015



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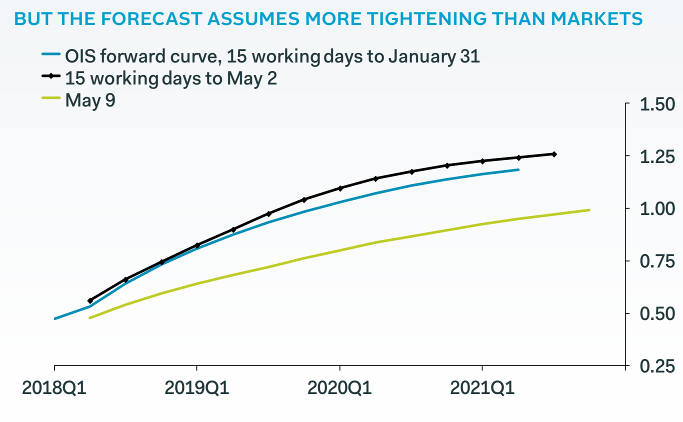
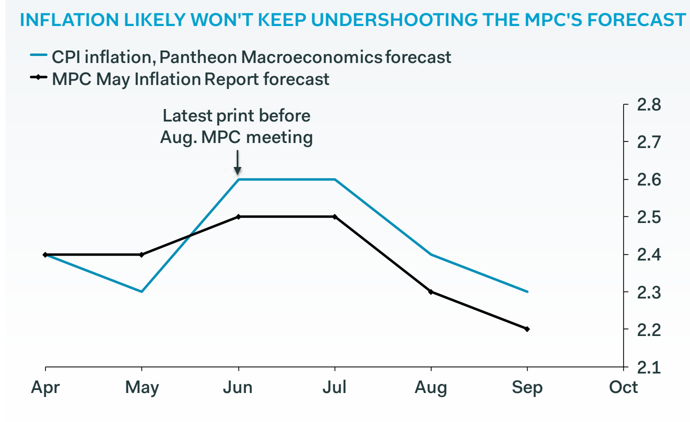
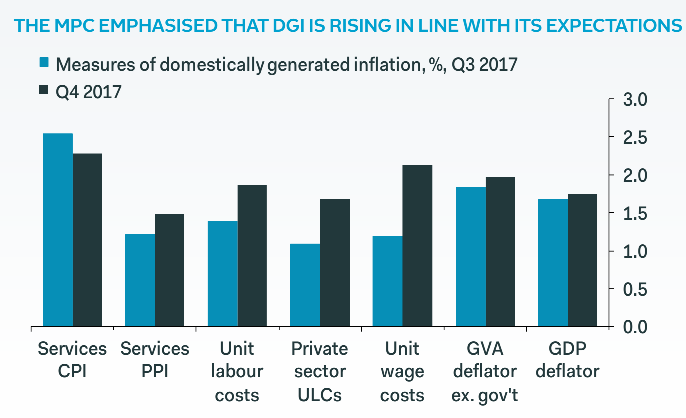




Meanwhile, the MPC revised its inflation forecast down largely due to weakness in import-intensive sectors. Since sterling's depreciation, pass-through from world export prices to U.K. import prices has been running at about 50%, below the 60% rate the Bank anticipated. In previous forecasts, the MPC assumed that gap would close, but now, it judges that only half of the shortfall will be made up over coming quarters. *By contrast, the MPC highlighted that most measures of domestically-generated inflation have been "strengthening as anticipated" and have "...moved closer to their target-consistent ranges".*



By emphasising that little has changed since February, when it alluded to raising rates before the end of this year, the MPC has implicitly signalled a greater-than-evens chance of hiking in August. *As a result, yesterday's drop in market-implied odds of an August hike below 50% can't be reconciled with the MPC's message.*

Granted, the risks to the MPC's forecast for GDP growth of 0.4% in Q2 are skewed to the downside. Our chart of the week, on page three, shows that April's PMIs are consistent with growth of just 0.2%. But we are only one month in to the quarter, and the PMIs' error margin is wide. ***Moreover, inflation likely will exceed the MPC's forecast before August, albeit slightly.*** Inflation looks set to edge down by one-tenth in April and May, from 2.5% in March, but then jump to 2.6% in June as the recent increase in oil prices and forthcoming increases in consumers' energy charges filter through. Our June forecast is 0.1pp *above* the MPC's, partly because its forecast doesn't account for the further $4 rise in oil futures since May 2.

Finally, the MPC will be conscious that the window of opportunity for raising rates could disappear after August, as Mrs. May will have to decide in Q4 whether to leave the E.U.'s customs union. Whatever decision she makes will anger one wing of the Tory party, potentially triggering a leadership challenge or a general election. The MPC's commitment to a gradual pace of tightening and its desire to regain scope to cut Bank Rate again, if need be, point to action before political uncertainty resurfaces. *So, while sub-par activity data easily could lead to a longer delay and the MPC has not explicitly signalled the timing of the next move, we're still pencilling-in an August hike.*

The U.K. Economic Monitor will not be published from May 14 through May 18. Publication will restart Monday, May 21.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, May 7

- **U.K. public holiday**

Tuesday, May 8

- **D: Halifax House Prices (4)/08:30 BST**

The three-month average of year-over-year growth in house prices fell to **2.2%** in April, from 2.7% in March, due to a huge 3.1% month-to-month fall. Halifax's data, however, are very volatile and April's sharp fall followed a 1.6% gain in March.

Wednesday, May 9

- **D: BRC Retail Sales Monitor (4)/00:01 BST**

Year-over-year growth in like-for-like sales plunged to **-4.2%** in April, from +1.4% in March. Most of the drop was due to the early timing of Easter this year, though the underlying picture was weak too.

Thursday, May 10

- **D: RICS Housing Market Survey (4)/00:01 BST**

The house price balance fell to **-8** in April, from zero in March. But house purchase demand is no longer falling rapidly; the new buyer enquiries balance rose to -3—its highest level since August—from -15 in March.

- **D: Industrial Production (3)/09:30 BST**

Production rose by **0.1%** month-to-month in March, as assumed in the preliminary estimate of GDP. Quarter-on-quarter growth in production in Q1 was revised down to 0.6%, from 0.7% in the preliminary estimate of GDP, but the revision has no impact on GDP growth to one decimal place.

- **D: Construction Output (3)/09:30 BST**

Construction output fell by **2.3%** month-to-month in March, matching the consensus and the estimate used for preliminary Q1 GDP. Revisions in previous months mean that output fell by 2.7% quarter-on-quarter in Q1, less than the 3.3% drop incorporated in the preliminary estimate of GDP, but the revision is too small to impact GDP growth to one decimal place.

- **D: Trade (3)/09:30 BST**

The trade deficit rose to **£3.1B** in March, from £1.2B in February. Higher energy prices are partly to blame; the deficits in oil and fuels were £0.2B and £1.2B, respectively, above their 12-month averages in March.

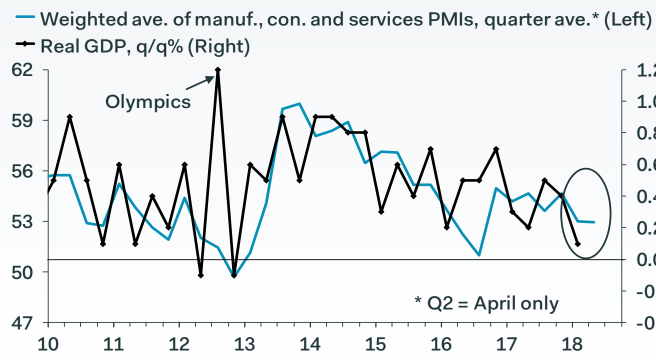
- **D: MPC Meeting & Inflation Report (5)/12:00 BST**

The MPC voted **7-2** to keep Bank Rate at **0.50%**; Ian McCafferty and Michael Saunders continued to vote to hike to 0.75%. The MPC has concluded that the slowdown in GDP growth in Q1 is just a blip. It continues to think that "an ongoing tightening of monetary policy" still is required. It cut its two-year ahead inflation forecast to 2.0%, from 2.2% in February, but the forecast assumes Bank Rate rises three times in the next three years, not twice, as markets expect.

Friday, May 11

- **No significant data released**

CHART OF THE WEEK: NO SIGN OF A REBOUND IN Q2



PANTHEON'S FINANCIAL FORECASTS

		End-month:				
	4pm Thu.	Jun	Sep	Dec	Mar 19	Dec 19
Bank Rate	0.50	0.50	0.75	0.75	1.00	1.25
3m Libor	0.67	0.80	0.90	1.00	1.10	1.40
12m Libor	0.95	1.10	1.20	1.30	1.50	1.80
2-year Gilt	0.77	0.90	1.00	1.20	1.30	1.80
10-year Gilt	1.42	1.60	1.70	1.80	1.90	2.20
30-year Gilt	1.85	1.90	2.00	2.20	2.30	2.50
FTSE 100	7688	7200	7300	7400	7500	7600
USD/GBP	1.35	1.38	1.38	1.40	1.40	1.40
EUR/GBP	1.15	1.15	1.17	1.22	1.22	1.22
Sterling TWI	78.7	79.4	80.4	81.9	83.1	83.1

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q1 18	*Q2 18*	*Q3 18*	*Q4 18*	*2017*	*2018*	*2019*
GDP, q/q%	0.1	0.4	0.3	0.3	-	-	-
GDP, y/y%	1.2	1.4	1.3	1.2	1.8	1.3	1.7
Employment, y/y%	0.7	0.5	0.6	0.6	1.0	0.6	0.7
Unemp. rate, %	4.3	4.3	4.3	4.3	4.4	4.3	4.1
Wkly earnings, y/y%	3.0	2.9	3.0	3.1	2.3	3.0	3.2
CPI, y/y%	2.8	2.4	2.4	2.1	2.7	2.4	2.0
RPI, y/y%	3.8	3.3	3.4	3.1	3.6	3.4	3.0
PSNB FY, £B	-	-	-	-	43	38	35
Cur. acc't., % GDP	-4.0	-3.8	-3.6	-3.4	-4.1	-3.7	-3.2
House prices, y/y%	4.4	2.6	1.0	0.0	4.6	2.0	1.5

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