The MPC has become more upbeat on the growth outlook, but left its inflation forecast unchanged.

The Bank cut its estimate of the unemployment rate consistent with sustainable wage growth to 4.5%.

As a result, the MPC thinks wage growth won't be consistent with the 2% inflation target until 2020.

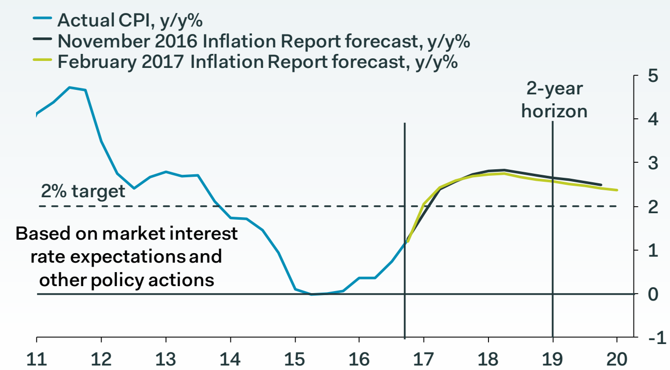
MPC Signals Newfound Supply Optimism; no Near-Term Rate Hike

The absence of hawkish undertones in the minutes of the MPC's meeting or in the *Inflation Report* forecasts took markets by surprise yesterday. ***The dominant view on the Committee remains that the economy will slow over the next couple of years, preventing wage growth from reaching a pace which would put inflation on track permanently to exceed the 2% target.***

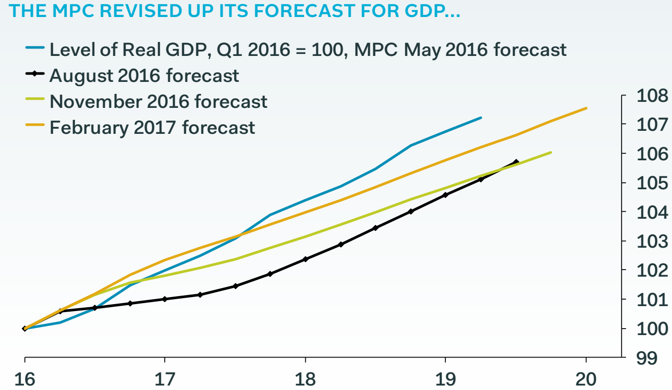
The Committee revised up its forecast for GDP growth this year to 2.0%, from 1.4% in November. But the MPC remains gloomier about the medium-term growth outlook than before the EU referendum. Indeed, the forecast for growth in 2018 was raised only slightly, to 1.6%, from 1.5%. In two years' time, the MPC thinks that the *level* of GDP will be 1.5% *lower* than it forecast in May, despite the easing of policy over the last six months. In addition, the Committee's "fan chart" shows that risks to the growth projections are skewed slightly to the downside. In the press conference, Mr. Carney emphasised that "the Brexit journey really is just beginning".

The MPC also did not alter its forecast for inflation materially in response to the healthier growth outlook. The Committee increased its forecast for CPI inflation in the first two quarters by one-tenth, to reflect higher-than-expected inflation in December. ***But it lowered the two-year ahead forecast for inflation—the most relevant for policy—to 2.6%, from 2.7%.*** Policymakers also thinks that the risks to their forecast now are balanced, rather than upwardly skewed.

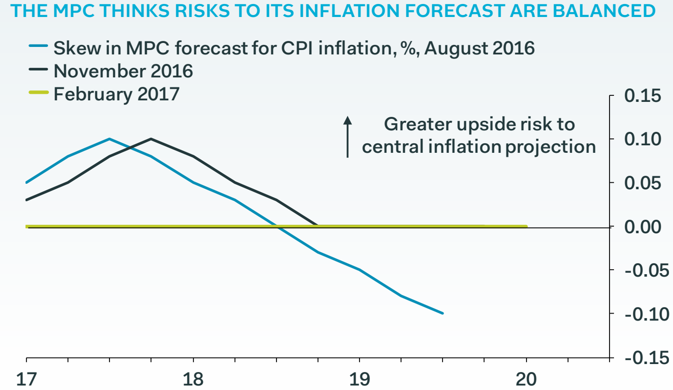
...BUT ONLY MADE MODEST REVISIONS TO ITS INFLATION FORECAST



THE MPC REVISED UP ITS FORECAST FOR GDP...



THE MPC THINKS RISKS TO ITS INFLATION FORECAST ARE BALANCED



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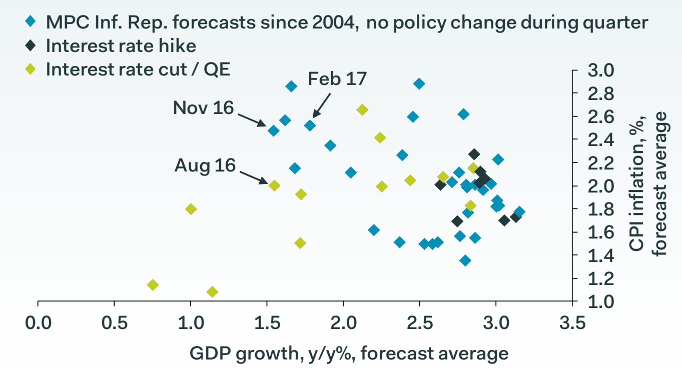
Admittedly, the MPC's forecast for CPI inflation in two years' time still is further above the 2% target than all the projections it made between 2004—when it began to forecast the CPI—and August 2016. The minutes noted that "some" members felt that the improvement in the growth outlook meant they had "moved closer to the limits" for looking through a period of above-target inflation. *Nonetheless, the outlook for GDP growth has had to be much stronger than currently anticipated for the MPC to raise rates in the past, as our next chart shows.*

THE MPC HAS HIKED ONLY WHEN GROWTH AND INFLATION ARE STRONG

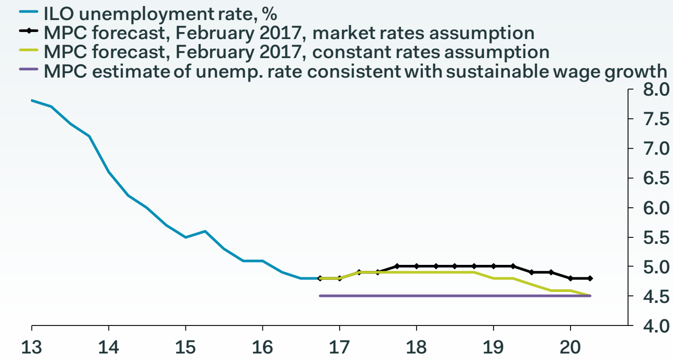


The consensus view on the Committee remains that *domestically-generated* inflation will be too low to warrant higher interest rates any time soon. Indeed, newfound optimism about potential supply was the main reason why the MPC did not revise up its inflation forecasts alongside its growth projections. *Specifically, the MPC now judges that the rate of unemployment the economy can achieve while being consistent with sustainable rates of wage growth is around 4.5%, down from 5% previously.*

The MPC based this judgment on a detailed review of its forecasting errors for wage growth over the last few years. It found that less than half of the errors were attributable to slow growth in productivity. The bulk of the errors reflected weaker labour bargaining power than it had expected.

The MPC estimates that if interest rates are kept on hold, it will take until 2020 for unemployment to reach 4.5%. If, instead, interest rates are raised in line

UNEMPLOYMENT WON'T BE CONSISTENT WITH 2% INFLATION UNTIL 2020



with markets' current expectations—investors thought before the MPC's meeting that the odds of a rate hike exceeded 50% in about one year's time—the MPC thinks the unemployment rate would not fall to 4.5% *at any point* within the next three years.

As a result, the MPC revised down its forecast for year-over-year growth in average weekly wages in both 2018 and 2019 to 3.25%, from 3.75%. It also lowered its projections for growth in unit labour costs in 2018 and 2019 by a quarter-point, to 2.25% and 2.75% respectively. Unit wage cost growth would have to exceed 3% for some time for the MPC to expect inflation permanently to exceed the 2% target. That's because goods, which typically fall in price over time, are mostly imported, so they keep inflation below the rate of growth of domestic labour costs.

Accordingly, the MPC's new forecasts clearly imply it thinks markets have jumped the gun in expecting Bank Rate to rise within the next couple of years. The MPC would seek to raise interest rates before the unemployment rate returned to 4.5%, because monetary policy has a lagged impact on the economy. But its new unemployment and wage forecasts suggest that the lift-off point for rates lies a long way ahead. *We agree with the MPC's judgement that wages will not pose a serious inflation threat over the next couple of years, enabling interest rates to remain at ultra-low levels while the economy struggles to adjust to the realities of Brexit.*

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THIS WEEK IN BRIEF

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

Monday, January 30

• **D: EC Economic Sentiment Indicator (1)/10:00 GMT**
The E.C.'s Economic Sentiment Index fell to **107.1** in January, from 108.5 in December. The confidence indicator for the services sector fell sharply to -1.8—the lowest level since May 2013—from +10.5 in December. In addition, retailers were their most downbeat since August.

Tuesday, January 31

• **D: Money & Credit (12)/09:30 GMT**
Households are adopting a more cautious attitude to borrowing. House purchase mortgage approvals rose only to **67.9K** in December, from 67.5K in November. The increase was very small, given that mortgage rates have fallen to a record low and that surveyors have reported rising buyer enquiries. Meanwhile, net consumer credit rose by just **£1.0B** in December, the least since May 2015.

Wednesday, February 1

• **D: Nationwide House Prices (1)/07:00 GMT**
The year-over-year growth rate of house prices slowed to **4.3%** in January, from 4.5% in December, due to a modest 0.2% month-to-month rise in prices.

• **D: Markit/CIPS Manufacturing PMI (1)/09:30 GMT**
The manufacturing PMI fell to **55.9** in January, from 56.1 in December. This decline primarily reflected a drop in the total orders balance to 57.9, from 58.5. This, in turn, was driven by a collapse in the export orders balance to 50.9, from 58.5. Growth in manufacturing output therefore now relies exclusively on domestic demand, despite sterling's drop.

Thursday, February 2

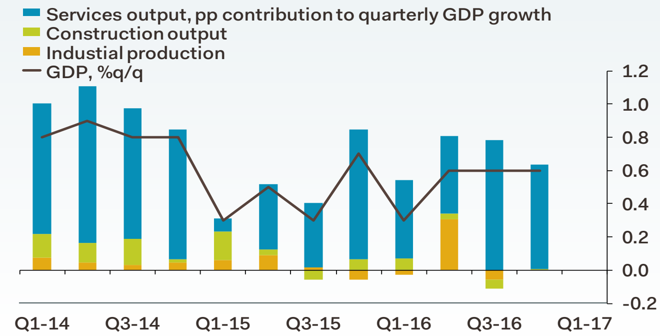
• **D: Markit/CIPS Construction PMI (1)/09:30 GMT**
The PMI fell to **52.2** in January, from 54.2 in December. It points to zero growth in construction output in Q1.

• **D: BoE Decision & Inflation Report (Q1)/12:00 GMT**
The MPC voted unanimously to keep Bank Rate at **0.25%** and to maintain the stock of gilt purchases at **£435B**. The Committee raised its forecast for GDP growth in 2017 to 2%, from 1.4% in November. But its forecast for GDP growth to slow to 1.6% in 2018 shows that it is still more concerned about the medium-term outlook than before the referendum. And while the Committee revised up its forecast for inflation over the next couple of quarters, it revised *down* its two-year ahead forecast—the most relevant indicator for policy—to 2.6%, from 2.7%.

Friday, February 3

• **D: Markit/CIPS Services PMI (1)/09:30 GMT**
Growth in the consumer services sector will slow sharply over the coming months amid high inflation and meagre job gains. Note that both Lloyds' Business Barometer and the EC's measure of services firms' confidence fell in January. As a result, we expect the services PMI to fall to **55.0** in January, from 56.1 in December. **Consensus: 55.8.**

CHART OF THE WEEK: CONSUMERS POWERED GDP GROWTH IN Q4



Contributions may not sum to totals due to rounding; agriculture excluded

PANTHEON'S FINANCIAL FORECASTS

	End-month:					
	3pm Thu.	Mar	Jun	Sep	Dec	Dec 18
Bank Rate	0.25	0.25	0.25	0.25	0.25	0.25
3m Libor	0.36	0.40	0.40	0.40	0.40	0.60
12m Libor	0.77	0.80	0.80	0.80	0.80	1.30
2-year Gilt	0.12	0.20	0.30	0.40	0.50	1.20
10-year Gilt	1.38	1.20	1.40	1.70	2.00	2.80
30-year Gilt	2.05	1.80	2.00	2.20	2.40	3.00
FTSE 100	7155	6800	6700	6600	6500	6800
USD/GBP	1.25	1.22	1.25	1.28	1.30	1.40
EUR/GBP	1.16	1.16	1.19	1.22	1.24	1.27
Sterling TWI	77.6	75.7	77.5	79.4	80.6	83.9

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q4 16	*Q1 17*	*Q2 17*	*Q3 17*	*2016*	*2017*	*2018*
GDP, q/q%	0.6	0.2	0.2	0.2	-	-	-
GDP, y/y%	2.2	2.0	1.5	1.1	2.0	1.3	1.5
Employment, y/y%	0.7	0.6	0.2	0.2	1.5	0.4	0.6
Unemp. rate, %	4.9	5.0	5.1	5.2	4.9	5.2	5.1
Wkly earnings, y/y%	2.5	2.7	2.3	2.5	2.5	2.5	2.8
CPI, y/y%	1.2	2.3	3.2	3.4	0.6	3.0	2.8
RPI, y/y%	2.1	3.1	4.0	4.2	1.7	3.7	4.0
PSNB FY, £B	-	-	-	-	65	65	55
Cur. acc't., % GDP	-5.2	-4.6	-4.5	-4.5	-5.0	-4.5	-4.0
House prices, y/y%	6.2	5.5	3.1	1.6	6.0	2.0	3.5

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