BoE turns hawkish but unlikely to mark the start of sustained rate rise cycle

- **The BoE appears to be trying to prepare the market for a rate hike - potentially as soon as May.**
- **A key assumption underlying its forecasts is that the Brexit process goes smoothly.**
- **With splits within the government over Brexit policy deepening and divergences with the EU widening, this assumption seems overly optimistic to us.**
- **While a rate hike in May is possible if a transition period is agreed upon before then, weak growth and falling inflation make a sustained rate rise cycle unlikely in our view.**

- **The BoE turned more hawkish in its February MPC commentary, stating that monetary policy may "need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November report."**

- **The BoE's new forecasts now see GDP growth of 1.8% in 2018 and 2019 compared to 1.6% and 1.7% previously - slightly above its estimate of potential (non-inflationary) growth of 1.5%. Average annual CPI forecasts for 2018 and 2019 remain the same and the unemployment forecast has been nudged down slightly.**

- **Reading between the lines of the statement, the BoE appears to be trying to prepare the market for another 25bp increase in its base rate to 0.75%, potentially as soon as its May meeting. The futures market now implies around a 70% probability of a 25bp hike by May 2018 and nearly a 50% probability of an additional rate rise by year end.**

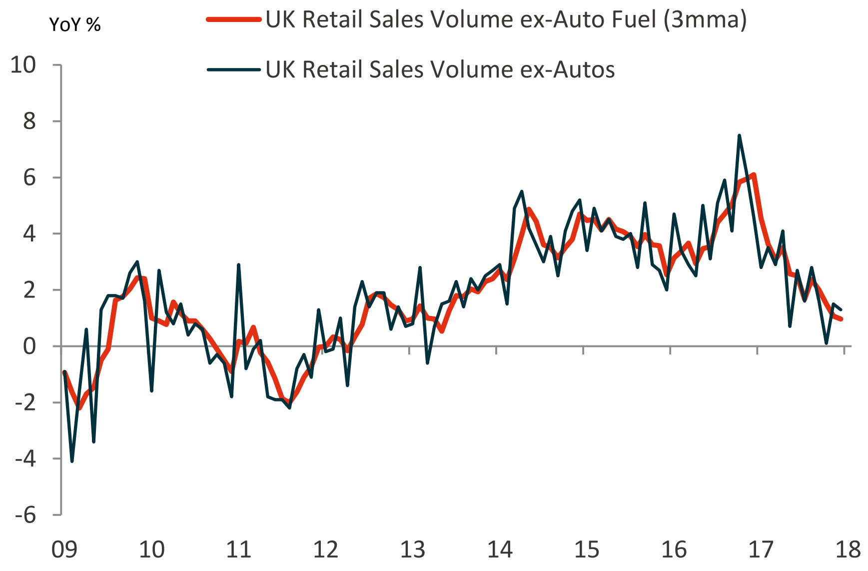
- **However, critical to the economic forecasts underlying the BoE's more aggressive stance is the explicit assumption that the Brexit process will be smooth. This implies a two-year transition agreement providing the UK status quo access to the single market is agreed upon as planned at the March European council meeting, and negotiations on the final state of the relationship thereafter go relatively smoothly. It also assumes continued strong global growth and stable markets.**

- **In our view, these assumptions are overly optimistic. Based on the growing hard-line stance currently being taken by pro-Brexit members of the Tory party on leaving the customs union, and the hardening of the positions of EU negotiators (particularly on receiving a written guarantee of no physical barriers along the Irish border and maintenance of the status quo across all aspects of the UK-EU relationship during the transition period), the risk of delay or even abandonment of a transition agreement is rising in our view.**

- **UK high frequency macro data has generally been on a weakening trend, with retail sales trending down, consumer and industry confidence weak, construction spending slowing and the housing market weakening. Manufacturing has been one of the few bright spots as the UK has benefited along with the rest of the world from the rebound in the global industrial cycle. However, with manufacturing making up only about 10% of GDP, it is unlikely to be able to compensate if weakness is sustained in other segments of the economy. It is also likely that the industrial cycle will moderate later this year in our view (see our Global Outlook report for details).**

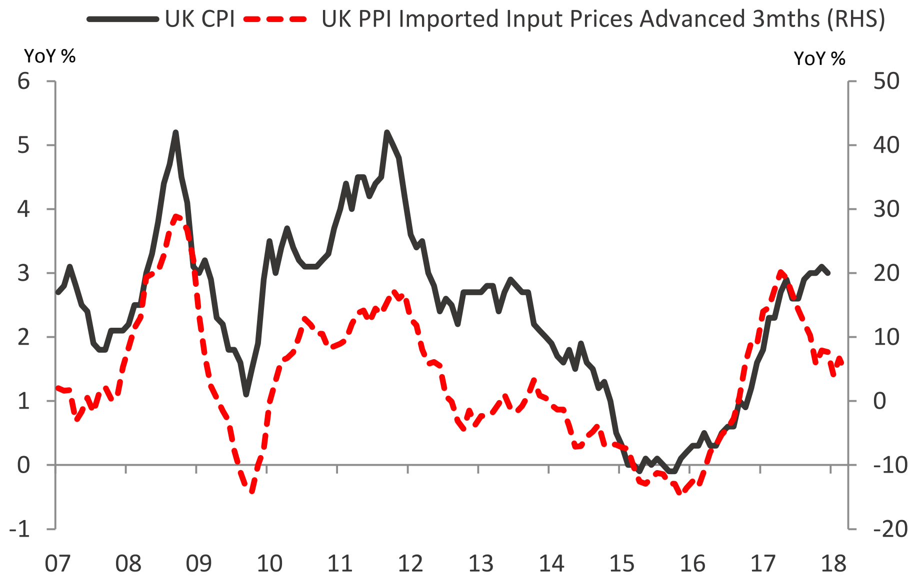
- **If political events do not unsettle markets in the next month or so, based on the BoE's analytical framework, it is possible the more hawkish members of the MPC may be able to convince a majority to push through a 25bp rate hike in May or August. However, given the weakening trajectory of economic growth and the housing market, as well as the likelihood inflation will fall over the course of the year as currency effects fades out, a sustained rate hiking cycle would seem unwarranted.**

UK retail sales continue to weaken



Source: Bloomberg

UK inflation likely to fall as currency effect wanes



Source: Bloomberg

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