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Special Coverage:

Bank of England cautiously hikes but opens door for steeper moves

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Key takeaways

- The Bank of England (BoE) hiked the base rate by another 0.25% on 16 Jun, taking it to 1.25%. Even though this marks the fifth consecutive rate hike from the BoE, markets saw the move as cautious because some had feared a 0.50% hike.
- The BoE "will be particularly alert to indications of more persistent inflationary pressures, and will if necessary act forcefully in response." This commitment to take more forcible action was interpreted as a nod towards 0.50% hikes over the next three meetings. With more a more hawkish outlook, gilt yields moved higher, particularly at the shorter end.
- We are likely to have to wait until the Autumn before inflation peaks, with the BoE now expecting inflation to rise above 11% in October. This is likely to keep markets volatile. The UK also has to contend with higher political risk as tensions over the Northern Ireland protocol rise.
- It's not all doom and gloom for the UK, with job vacancies still near a record high and business sentiment showing some resilience for now. Yet looking ahead, the consumer outlook is bleaker. We therefore prefer to take risk in the FTSE 100 which is more exposed to global companies and commodities. This fits into our broader approach of managing risks and providing some exposure to the increasingly stagflationary environment in Europe. We also look towards "quality" companies that we expect to be more resilient.

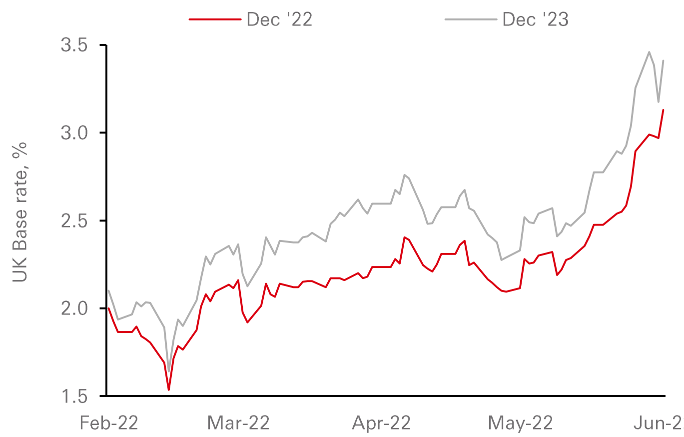
What happened?

- Last week's meeting of the BoE Monetary Policy Committee (MPC) was in-between the more pivotal May and August meetings where the detailed Monetary Policy Report (MPR) was published. Therefore, it was perhaps too much of an ask that the BoE would take the more hawkish, and less expected, route in hiking rates. The result was a comparatively modest hike of 0.25%, vs the US Fed's more aggressive 0.75% hike in the same week.
- Three of the nine members' voted for a 0.50% rate hike and felt that "monetary policy should lean more strongly against risks". Notable risks to the upside of inflation stemmed from the greater resilience in business sentiment compared to household confidence, which has plummeted to a new low.[1] The BoE also pointed to continued signs that high input inflation would be passed on to consumers while pay settlements "continued to be much higher than a year ago, with deals averaging just over 5%".
- Meanwhile job vacancies remain high, portraying a labour market that is still very tight and well-placed to weather further tightening in policy. To conclude the case for a more aggressive policy stance, the BoE now thinks that inflation will rise to slightly above 11% in October.
- There are concerns that the BoE is not waking up to what is already a stagflationary environment, though the central bank tried to inject some urgency by saying "The Committee will be particularly alert to indications of more persistent inflationary pressures, and will if necessary act forcefully in response". This did have the effect of investors repricing future rate forecasts to include 0.5% hikes in each of the next three meetings.

[1]According to data from Growth from Knowledge

- As the UK is such an open economy, the BoE is generally focused on the medium term, so the next year of two. This results in the BoE giving more weight to the path of GDP while looking through higher commodity inflation. With the May MPR forecasting no growth over 2023/24 and the most recent monthly GDP down 0.3%, the BoE has gone for a more cautious approach. Yet this will be data dependent: given all of the above reasons to be more hawkish the BoE forecast clearly think the epic fall in consumer confidence foreshadows some painful adjustments in spending. Should the economy hold up better than expected the BoE may have to hike more aggressively. Until then, it remains a more dovish outlier.

The BoE would have to move to 0.5% rate hikes to keep up with market expectations



Source: Bloomberg, HSBC Global Private Banking as at 16 June 2022.

Investment summary

- This initial reaction for GBP was to rise because, even though the 0.25% rise was quite dovish, the comment about acting "forcefully" was interpreted as more aggressive for rates over the coming year.
- To most UK mortgage holders, the prospect of the policy rate moving to the almost 3.4% would be hard to stomach. UK household deleveraging has put consumers on a firmer footing and high levels of savings during the pandemic should also help soften the squeeze on incomes. That said, overall leverage is high enough that market expectations of rate hikes are surely too hawkish. This should support government bonds in the coming months and we expect yields should start to meaningful fall toward the end of the year. Meanwhile the UK also has greater uncertainties to business regulation that have to potential to worsen now that tensions are rising with the EU over the Northern Ireland protocol.
- The BoE mentioned that companies have been able to pass on much of the higher import costs but as growth slows this may prove to be more difficult, especially as another likely steep rise in energy bills further squeezes household incomes. In comes as little surprise that consumer confidence has fallen to the lowest levels since the Growth from Knowledge series began in the 1980s. This does not bode well for the FTSE 250, where earnings are more tied to the consumer.
- This year we've had a preference for the FTSE 100, which has more of a skew towards energy and materials and has a greater share of foreign earnings. Strong earnings in these sectors have also helped bring valuations lower, despite the relatively strong performance this year – in short earnings have outpaced price performance. We expect oil can remain resilient in the coming months as demand is supported by a re-opening China and US driving season. Therefore, the strength of the FTSE100 adds up to an overall neutral position on the UK equity market as this is weighed up against the domestic risks.
- For us to become more positive on the outlook, we would like to see volatility ease and a consensus to form over the direction of growth and inflation. We aren't there yet, however, and we continue with our relatively conservative approach: preferring to more "quality" companies, while also keeping a balance between value and growth styles. To provide some protection against stagflation, we have a sector preference for energy and materials, which plays into an exposure to FTSE 100 equities.

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