CIO Special

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BoE's path to lower rates: what's next?

Key takeaways

- The Bank of England (BoE) is likely to cut the base rate in the coming quarters – potentially as soon as June 20 – on the back of expected ongoing disinflation and to provide further support for the economic recovery.
- BoE decision-making is heavily influenced by its inflation forecasts, which expect a decrease towards the 2% target by the end of 2025. Its revised GDP growth projections and changes in labour market conditions will also guide the timing and magnitude of the anticipated rate cuts.
- Given the still high degree of uncertainty surrounding the near-term path of UK inflation, markets are likely to remain volatile as market participants adjust their interest rate expectations in response to incoming data.

01 BoE holds rates steady but eyes cuts as inflation eases

As widely expected, the Bank of England (BoE) left its key interest rate (Bank Rate) unchanged at 5.25% for the sixth time in a row on May 8. The voting behaviour of the Monetary Policy Council (MPC) members and parts of the central bank's statement make an imminent rate cut increasingly likely, possibly as soon as the next BoE meeting on June 20. In the press conference that followed, BoE Governor Andrew Bailey said that it was "likely that we will have to cut the base rate in the coming quarters".

In contrast to the March meeting, when the vote was 8:1 in favour of keeping rates on hold, the May 8 result was slightly more dovish, with seven votes for leaving rates unchanged and two votes for a rate cut. In line with his previous comments, BoE Deputy Governor Dave Ramsden joined Swati Dhingra in voting for a rate reduction. Ramsden's move to the dovish camp can be seen as a sign that the bar for a rate cut is now lower than before.

Furthermore, the BoE's statement noted that the Monetary Policy Committee "would consider forthcoming data releases and how these informed the assessment that the risks from inflation persistence were receding". At the press conference, Governor Andrew Bailey said that a rate cut at the next meeting in June was neither to be ruled out nor a "fait accompli" and suggested "it is likely we will need to cut bank rates over the coming quarters...and possibly more so than priced in to market rates".

The BoE's updated inflation forecasts underline the increased likelihood of monetary easing going forward: in its May Monetary Policy Report (MPR), the BoE expects annual inflation to have fallen towards 2% in April and to remain close to this level in May and June, broadly in line with the expectations expressed in the February report. In the second half of the year, the BoE then expects inflation to climb above 2% again, reaching 2.6% in Q4, mainly as the positive base effects in energy prices fade. Energy-adjusted consumer price inflation is expected to be more stable at around 3%, which policymakers attribute to persistently high services inflation. While core inflation for goods and food is expected to continue declining soon, price increases for services are expected to moderate only slowly and remain high due to their high labour

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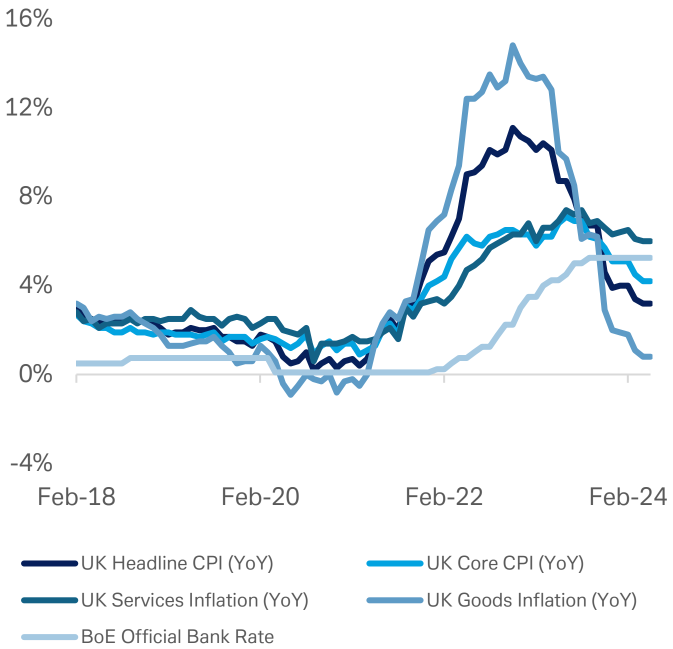
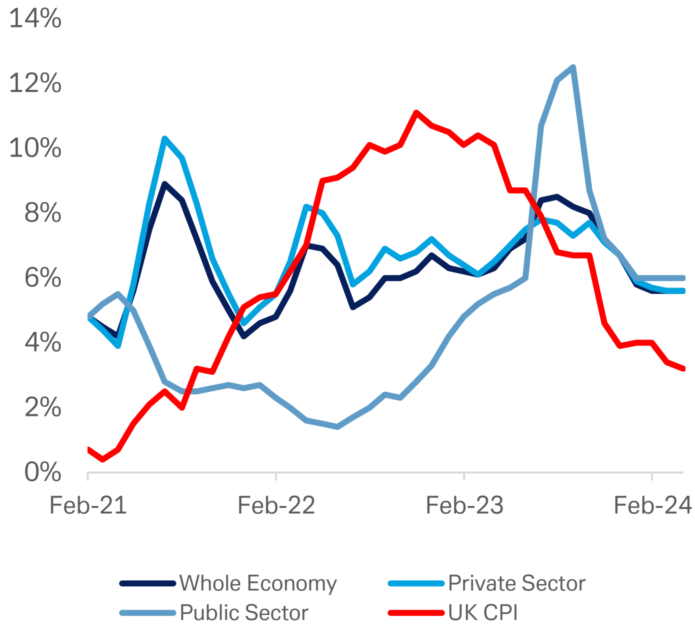
Figure 1: Inflation trends in the UK vs. BoE key Bank Rate



Source: Bloomberg L.P., Deutsche Bank AG. Data as of May 2024.

Figure 2: Average weekly earnings growth for UK economy and different UK sectors vs. CPI



Source: Bloomberg L.P., Deutsche Bank AG. Data as of May 2024.

intensity and significant increases in rents. After peaking at 7.4% last year, the latest annual inflation rate for services was still quite high at 6.0% in March. However, the sequential – i.e. monthly – rate of price increases has recently moderated, which the BoE believes will contribute to annual services inflation falling below 5% by the end of Q3 2024.

All this should lead to annual headline inflation of 2.6% in the fourth quarter of 2024, 10 basis points lower than forecast in the previous MPR. By the end of 2025, inflation is expected to fall to 1.9%, below the BoE's 2% target, and then further to 1.6% by Q4 2026. The updated inflation forecasts reflect policymakers' assumption that much of the pass-through from import prices to consumer prices has already taken place.

In addition, indicators of inflation expectations among both households and businesses remain moderate. According to the latest quarterly Ipsos survey, households' expectations for inflation one year and five years ahead have fallen to 3.0% and 3.1% respectively, with both of them close to their historical averages. In the latest DMP survey, companies' inflation expectations fell to 3.1% for one year and 2.7% for three years ahead.

Despite the increased uncertainty surrounding labour market data, which has been volatile recently, the BoE expects the unemployment rate to approach its estimate of the non-accelerating inflation rate of unemployment (NAIRU) of 4.25% around mid-2025, before peaking at 4.75% towards the end of the forecast period. At an estimated 5.25% in the fourth quarter of 2024, wage growth is likely to be higher in the short term than projected in the February MPR (4.0%) but is likely to fall faster than previously expected over the medium term to 2.25% in Q4 2025 (February MPR: 2.75%) and 1.5% in Q4 2026 (February MPR: 1.75%).

The BoE has raised its GDP growth forecasts by around 50 basis points over the forecast period. It expects real GDP to grow by 0.5% in 2024, 1% in 2025 and 1.25% in 2026, mainly due to the projected stronger population growth and the fiscal easing measures included in the Spring Budget. On the other hand, the rise in capital market interest rates since February will have a dampening effect on GDP, although this will be partly offset by less restrictive financing conditions elsewhere.

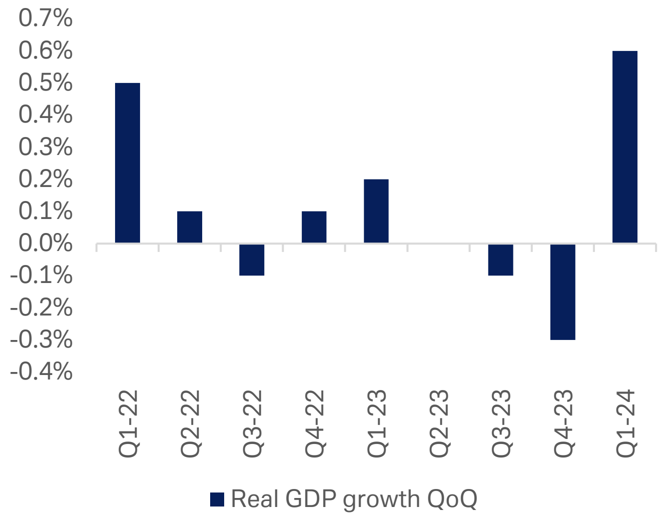
02 UK economic growth bounced back

The brighter outlook for growth was confirmed by Q1 GDP data released on Friday May 9. As expected, the UK economy emerged from a mild technical recession in the first quarter of this year. According to the first estimate published by the Office for National Statistics (ONS), real GDP growth in the UK in Q1 came in at a better-than-expected 0.6% quarter-on-quarter (QoQ). After two quarters of negative growth (-0.3% in Q4 and -0.1% in Q3 of 2023), the consensus of analysts and the Bank of England (BoE) had expected growth of 0.4%. This positive start to the year is in line with the economic recovery in most European economies and the Eurozone.

Compared with the same quarter one year earlier, the UK economy is likely to have grown by 0.2% in real terms in Q1. The positive development was broadly based, affecting 13 out of 20 sub-sectors, compared with growth in only six sub-sectors in the previous quarter.

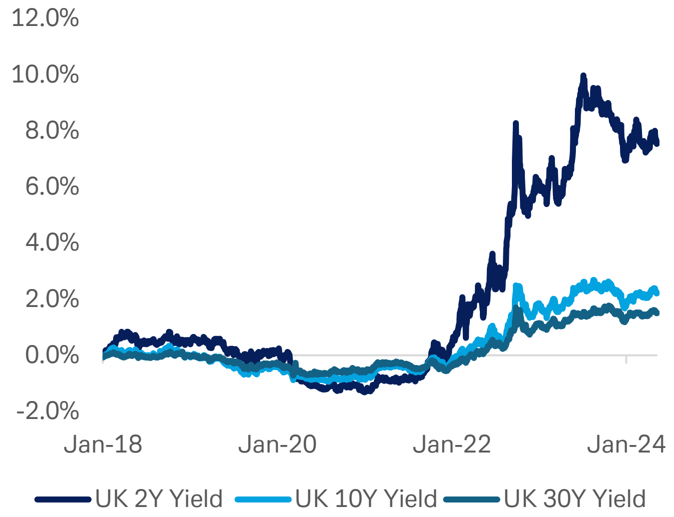
The services sector, which accounts for more than 70% of the country's economic output, recorded an increase in output of 0.7% QoQ – the first positive print since Q1 2023. The positive trend extended to all three

Figure 3: UK real GDP growth



Source: Refinitiv Datastream, Deutsche Bank AG. Data as of May 2024.

Figure 3: Gilt yields movements across different maturities over the past 5 years (normalised)



Source: Bloomberg L.P., Deutsche Bank AG. Data as of May 2024.

months of Q1 and 11 of the 14 sub-sectors were able to increase their activity. For example, above-average growth was recorded in the wholesale and retail trade segments and in transport and logistics.

Industrial output grew even more strongly than in the services sector, starting the new year with growth of 0.8% QoQ after contracting -1.1% in Q4 2023. The manufacturing sector was particularly dynamic, growing by 1.4% QoQ, with eight of the 13 sub-sectors expanding production. Growth was once again driven by motor vehicles, which expanded output for the sixth consecutive quarter (+5.7% QoQ). Manufacturing of basic metals (+3.1% QoQ) and food, beverages and tobacco (+1.5% QoQ) also performed well. However, this was partly offset by a -3.6% decline in textile, clothing and leather goods output, which fell for the sixth consecutive quarter. Water supply, sewerage and waste management and mining also made negative contributions to growth.

On the expenditure side of GDP, real household consumption expenditure rose by 0.2% QoQ, after having contracted in the previous two quarters. Within private consumption, housing, water and fuel, recreation and culture, restaurants and hotels, and household goods and services were the main contributors to growth. Real government consumption expenditure increased by 0.3% QoQ (after a 0.1% increase in Q4 2023), mainly due to higher activity in health and transport, partly offset by declines in public administration, defence, and education.

The growth momentum of gross fixed capital formation by UK businesses remained positive but slowed from +1.4% in Q4 2023 to +0.9% QoQ in Q1 2024. Compared with the first quarter of the previous year, business investment fell by -0.6% YoY.

Despite declining exports (-1.0% QoQ), foreign trade made a positive contribution to UK GDP growth. This was because imports, which are a negative factor in calculating GDP, fell much more sharply at -2.3% QoQ. The fifth consecutive quarterly decline in exports was due to a -3.4% QoQ slump in goods exports (including smaller deliveries of machinery and transport equipment as well as fuel), while services exports rose by 1.0% QoQ (mainly travel and transport). Imports declined by -0.3% QoQ in Q4 2023 and then fell faster in Q1 2024, due largely to a -2.9% QoQ decline in goods imports (mainly less machinery and fewer vehicles), while imports of services fell by "only" -1.3%.

Early indicators show a robust start to Q2. The S&P Global UK PMI composite index rose to 54.1 in April, well above March's robust 52.8. This not only kept the UK private sector sentiment indicator above the 50-point expansion threshold for the sixth consecutive month, but also signalled the most dynamic growth of the past 12 months. The services sector recorded a dynamic and accelerating upturn with a PMI of 55, while the leading indicator for the manufacturing sector eased slightly to 49.1 in April, after briefly breaching the 50-point threshold in March (50.3). Service providers reported an acceleration in the growth of their order books, while manufacturers recorded a decline.

Input costs rose for both service providers and manufacturers in April, albeit at a slightly slower pace than in March, resulting in the highest overall rate of input price inflation since July 2023. The outlook for the UK manufacturing sector remained positive in April, with firms anticipating a recovery in demand, new product launches, efficiency gains and improving market conditions. Firms in the services sector remained confident about their business prospects over the next 12 months, with signs of a rebound in customer demand and long-term expansion projects.

According to today's labour market data, regular pay excluding bonuses rose 6.0% YoY in the first three months of 2024, slightly above expectations of 5.9% YoY, but remaining at the low level of 2022. However, private sector regular pay, a key measure for the BoE, eased slightly to 5.9% YoY, somewhat below the BoE's latest forecast.

Meanwhile, the unemployment rate rose to 4.3%, its highest level since the three months to July 2023, although the ONS cautioned that the survey used to calculate the unemployment rate is still undergoing an audit. Job vacancies continued to fall in the three months to April 2024, down 26,000 from the November to January period, adding to signs of a cooling labour market. BoE chief economist Huw Pill said the labour market remained tight by historical standards, but policymakers could consider cutting interest rates over the summer.

Against this background, market participants slightly adjusted their expectations for an initial 25 bps cut of the BoE bank rate at the next meeting on June 20. The probability priced in by money market futures currently stands at 57% compared to 55% ahead of the BoE May meeting. In addition, markets are now pricing in 77 bps of cumulative rate cuts by the end of Q1 2025, i.e. around three full rate cuts of 25 bps each.

In the currency markets, the GBP started the week by recovering ground against the USD following the BoE meeting, while remaining fairly stable against the EUR.

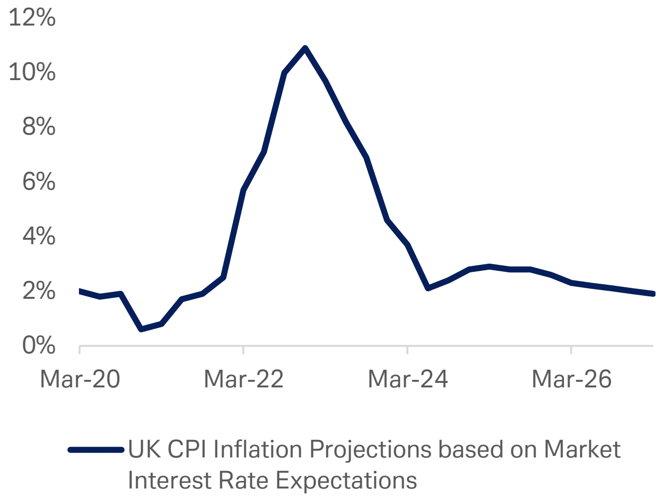
03 "After the meeting is before the meeting"

Currently, money market futures are pricing in a first full rate cut of 25 bps at the BoE meeting on August 1, followed by two more 25 bps cuts by the end of Q1 2025. However, with monetary policy working with a lag of six to eight quarters, some removal of policy restraints is likely to be appropriate to ensure that the risks to the inflation outlook remain broadly balanced. We remain comfortable with our longstanding forecast of the BoE initiating the policy turnaround on June 20 by cutting the policy rate to 5.0%.

We expect this initial step to be followed by three further cuts of 25 bps each by the end of Q1 2025, bringing the BoE's policy rate to 4.25% by the end of March 2025.

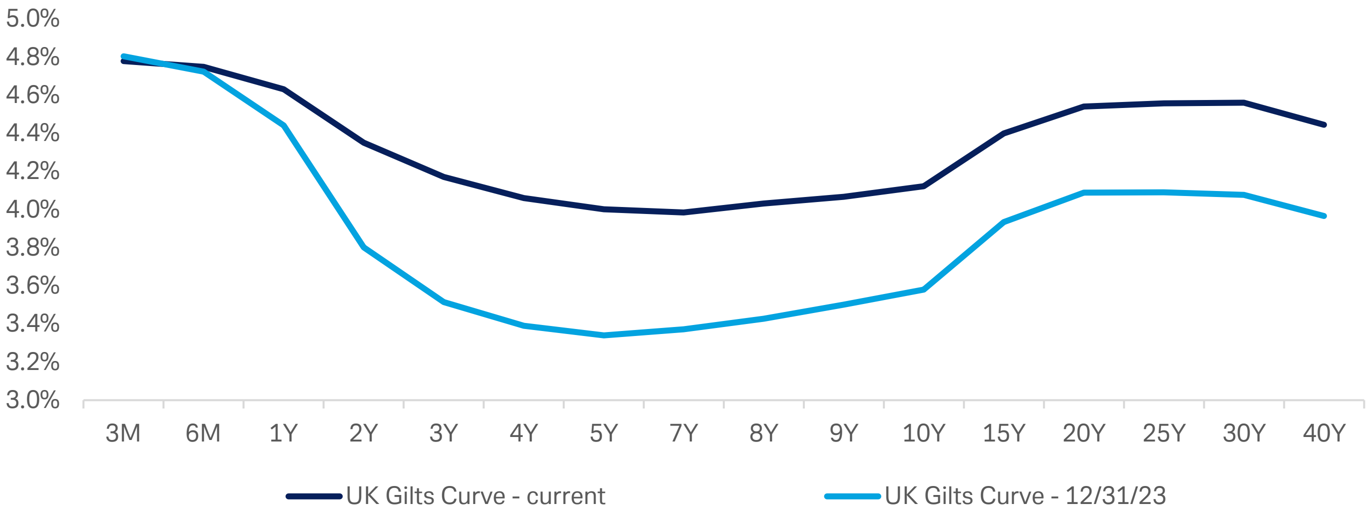
Given the still high degree of uncertainty surrounding the near-term path of UK inflation, markets are likely to remain volatile as market participants adjust their interest rate expectations in response to incoming data. If markets feel compelled to price in a somewhat faster easing path, this should tend to depress gilt yields, especially at the shorter end, and gradually contribute to a normalisation of the yield curve.

Figure 5: UK CPI



Source: Bloomberg L.P., Deutsche Bank AG. Data as of May 2024.

Figure 4: Gilt yield curves – current vs. end-2023



Source: Bloomberg L.P., Deutsche Bank AG. Data as of May 2024.

Glossary

The Bank of England (BoE) is the UK central bank.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

The Eurozone is formed of 20 European Union member states that have adopted the euro as their common currency and sole legal tender.

Gilts are bonds that are issued by the British Government.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Bank of England's Monetary Policy Committee (MPC) is responsible for making decisions about Bank Rate.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

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