FLASH

Brief updates on portfolios, markets & more 19 June 2024

BOE June preview: Holding Steady Before Elections?

PRIVATE BANKING

Executive summary:

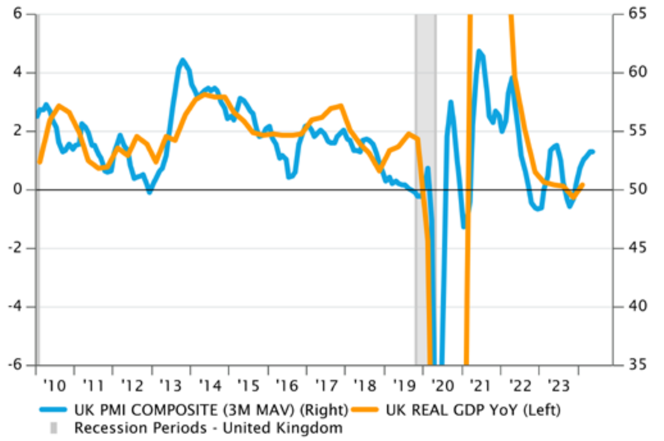
The Bank of England's Monetary Policy Committee meets on June 20th with expectations set for maintaining the current Bank Rate amid recent economic and inflationary developments. Despite a strong initial performance in June, the UK government bonds have stagnated since the last BOE meeting.

- Watch This: The focus is on the number of MPC members supporting a rate cut (currently 2 out of 9) and any forward guidance regarding future rate adjustments
- Market Strategy: Preference for the short end over the back end of the UK government yield curve continues, as GBP strengthens amidst differing economic dynamics between the US and UK.

Macro update: resuming growth amid persistent inflationary pressures

The UK's economy shows signs of robust recovery from the 2023 recession, with Q1 witnessing a 0.6% GDP growth driven by private investment. Despite a slowdown expected post-Q1, the economy should continue to grow near its long-term potential, though restrictive monetary policy remains a challenge.

Chart 1: Economic indicators point toward an improving growth dynamic



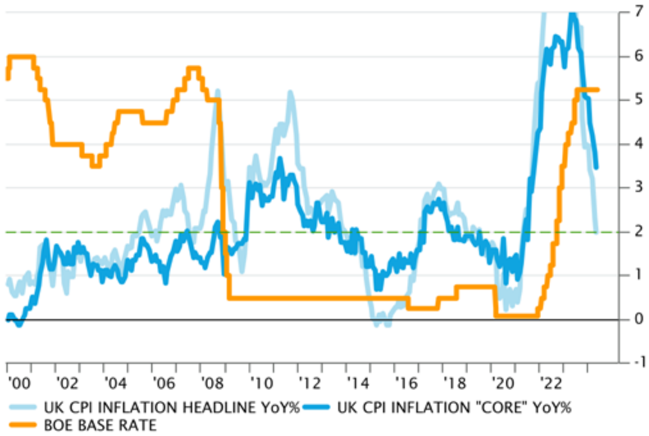
Source: Factset

Inflation presents a mixed picture. While core inflation (excluding food and energy) has increased due to strong demand and rising wages, the overall annual inflation rate is on a downward trend, aligning closer to the BOE's 2% target. However, unexpected early-year inflationary pressures and persistent wage growth warrant caution from the central bank.

What to expect from the BoE meeting? NO change

The Bank of England is expected to maintain its Bank Rate at 5.25% on June 20th. Since the last meeting, where 2 out of 9 Monetary Policy Committee members favored a 25bp rate cut, inflation and wage data have continued to exceed expectations. Consumer price data for May, released this morning, show that headline inflation is back on the BoE 2% target for the first time in three years. However, May's data also reveal resilient underlying inflationary pressures ("core" CPI +0.5% in May, +3.5% YoY) that should lead the BoE to remain on hold for the time being. The vote split for the likely "no change" decision could offer clues about potential shifts in MPC members' views. While growth and underlying inflation drivers suggest a delay in rate adjustments, the Bank is expected to wait until its September 18th meeting to begin reducing the Bank Rate. The August 1st meeting is probably too soon for such decisions, and the Bank may seek further clarity on the policies of the new government post-July 4th elections. Nonetheless, the trend towards a recalibration of interest rates in the medium term is clear. The UK's monetary policy needs to remain restrictive for now, and any rate cuts must await a sustained easing in inflationary pressures.

Chart 2: The Base Rate will likely decrease as inflationary pressures abate

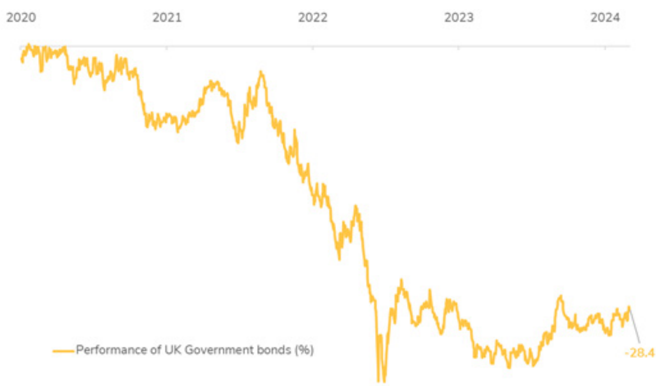


Source: Factset

UK Government Bond Yields: a cautious market

Despite a strong start in June, UK government bonds have shown a tepid performance, with continued negative returns year-to-date. Market anticipation of BOE actions has shifted throughout 2024, now expecting a slower pace of rate cuts.

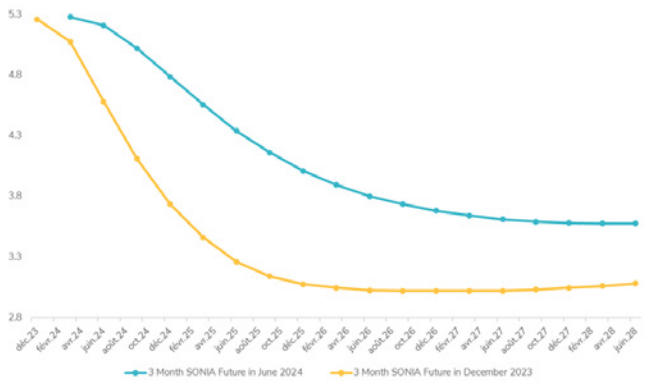
Chart 3: Total Return of UK Government B1onds over the last four years



Source: Bloomberg

The strategy of "one rate cut per quarter" is favored, benefiting the short end of the UK yield curve. However, the back end remains unattractive, influenced by the ongoing reduction of the BOE's balance sheet.

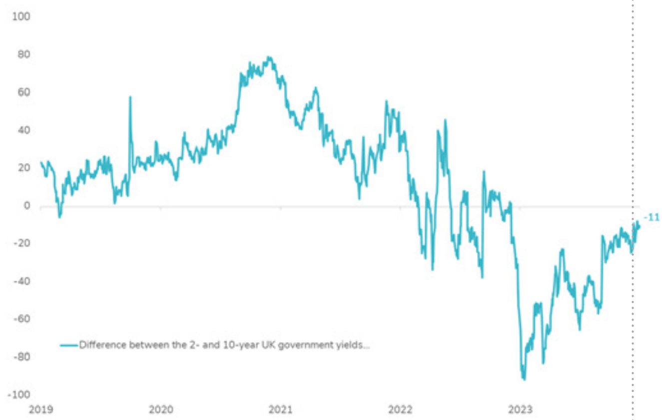
Chart 4: Market Expectations for BoE Official Bank Rate: Today vs. December 2023



Source: Bloomberg

Finally, the differential between 5-year US and UK yields, which has tightened since the last meeting, illustrates the contrasting economic trajectories of the UK and US, aiding in the slight strengthening of the GBP.

Chart 5: Yield Differential between 5-year US and UK Yields and USD/GBP Exchange Rate



Source: Bloomberg

The differential between 5-year US and UK yields has remained relatively narrow post-pandemic, fluctuating between 0 and 0.5%, except for notable events such as the UK government's 'mini-budget' crisis in September 2022, which caused an unprecedented surge in UK bond yields. However, since the last BoE meeting, this differential has narrowed from 45bps to 30bps, reflecting the contrasting dynamics between the UK's positive momentum and the US's deterioration. This has contributed to a slight strengthening of the GBP.

Chart 6: Yield Differential between 2-year and 10-year UK Yields (%)

Source: Bloomberg

Conclusion

The June BOE meeting is expected to mirror the non-eventful nature of May's meeting, with no significant impact on the bond market anticipated. The focus remains on the short end of the yield curve, guided by the ongoing balance sheet reduction and a steepening yield curve. As we approach the general elections, the BOE's cautious stance is likely to prevail, underscoring the need for investors to stay alert to subtle market cues.

For further information

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