WELLS FARGO

International Commentary — April 17, 2024

Bank of England Set To Join The 'Higher For Longer' Club

Summary

- The U.K. economy has continued along its disinflation path in early 2024, but at a more gradual pace than previously, as this week's wages and price data both surprised to the upside. At the same time, there are nascent signs of U.K. economic recovery. Sentiment surveys have been on an overall improving trend for the past several months, while January and February GDP outcomes point to a return to positive growth after the U.K. economy contracted during the second half of 2023.
- A slower pace of disinflation could make Bank of England (BoE) policymakers cautious about lowering interest rates prematurely, while signs of economic recovery arguably reduce the urgency for monetary easing. **Against this backdrop, we now forecast later easing than previously from the BoE. We forecast an initial policy rate cut to 5.00% at the August monetary policy meeting, followed by 25 bps rate cuts in November and December, for a cumulative 75 bps of rate cuts this year, which would see the policy interest rate end 2024 at 4.50%.** We see a further cumulative 125 bps of BoE policy rate cuts in 2025, which would see the central bank's policy rate end next year at 3.25%.
- Overall we expect the BoE to deliver modestly more easing than anticipated by market participants this year, and forecast noticeably more easing than expected by market participants next year. Over the medium-term, that could contribute to downward pressure on shorter-term U.K. bond yields, and see the pound underperform relative to many other G10 currencies over time.

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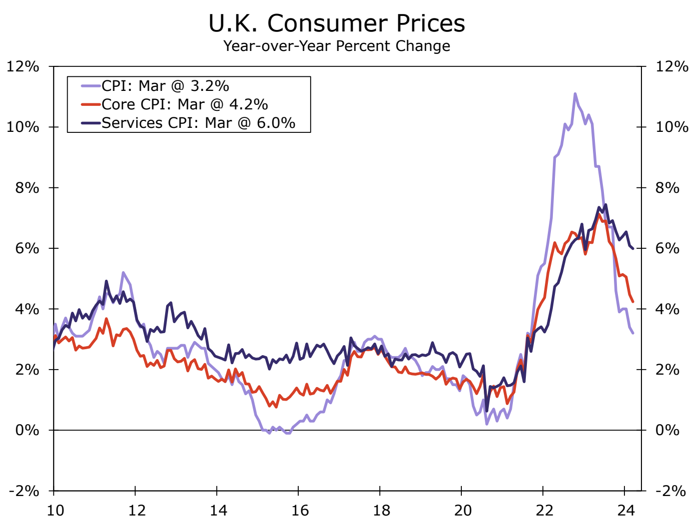
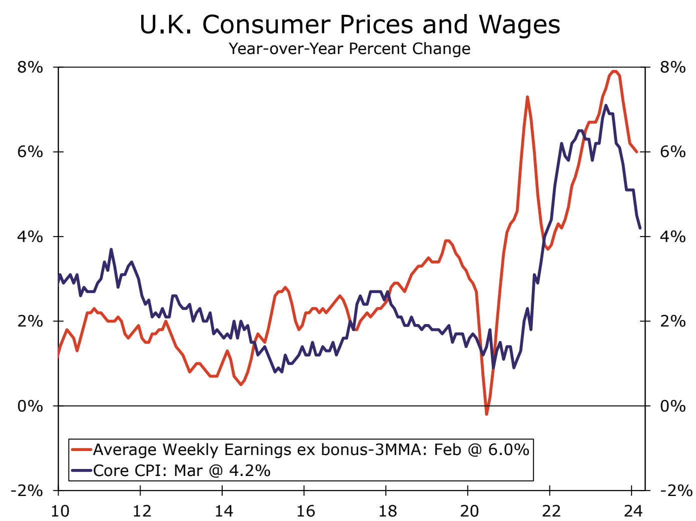
A Slowdown in the U.K. Inflation Slowdown

A range of important economic figures from the U.K. this week pointed to an ongoing easing of inflation pressures, though perhaps not as quickly as Bank of England (BoE) policymakers might have hoped for. Most notably, the U.K. March CPI surprised to the upside as headline inflation slowed to 3.2% (versus a consensus forecast for 3.1%), and the core CPI slowed to 4.2% (forecast 4.1%). Services inflation barely edged lower to 6.0%, versus an expected print of 5.8%. While the March figures represented some further progress on the disinflation front, the improvement was much less than what was seen in February. Core and services inflation in particular—that is, measures of underlying inflation—remain well above the 2% inflation target.

Energy-related base effects should see headline inflation slow sharply in April, and while base effects will also be beneficial for core and services inflation, we expect these underlying inflation measures will follow a more gradual path, relative to headline inflation, toward the central's bank inflation target. The latest labor market figures are, in our view, also consistent with only a gradual deceleration of services and domestic inflation. Those data showed some further slowing in wage growth, but at a measured pace. For the three months to February, average weekly earnings excluding bonuses rose 6.0% year-over-year, a bit less than the 6.1% increase seen in January, but higher than the consensus forecast for a 5.8% gain. Private sector earnings rose 6.0%, while public sector earnings rose at a slightly faster 6.1% pace. To be sure, there are some signs of softening in the labor market that could portend a further slowdown in wage growth ahead. While acknowledging some caution surrounding labor market data given the low response rate to the surveys recently, data nonetheless showed the unemployment rate rising to 4.2% for the three months to February, compared to 4.0% for the three months to January. In addition, employment declined by 156,000 in the three months to February compared to the three months to November. The loosening in the labor market and the slowing in wage growth should allow for Bank of England rate cuts in the months ahead, but could also make central bank policymakers somewhat cautious about just how aggressively to ease their monetary policy stance.



Source: Datastream and Wells Fargo Economics



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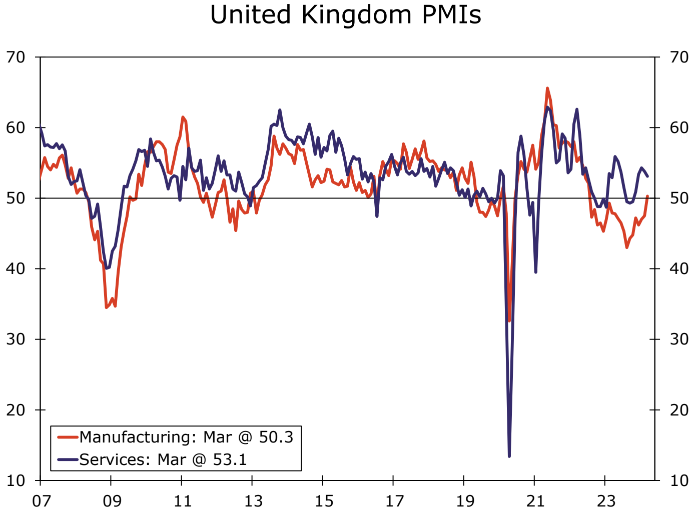
U.K. Economy Shows Some Signs of Life

Alongside some signs that disinflation is proceeding at a more gradual pace, there are also tentative hints that the U.K. economy has stabilized and that momentum is building toward economic recovery. The U.K. manufacturing and service sector PMIs, which have been on an improving trends for several months now, offer the clearest signs of an approaching economic recovery. The services PMI has eased a bit in the past couple of months but, at 53.1 in March, is still comfortably in expansion territory and up from a recent low of 49.3 last September. Meanwhile, the manufacturing PMI jumped to 50.3 in March, reaching expansion territory for the first time since July 2022, and up from a recent low of 43.0 in August last year. The improvement in sentiment surveys is starting to be corroborated, to some extent, by the official U.K. GDP data. February GDP rose a modest 0.1% month-over-month, driven mostly by a 1.1% gain in industrial output as services activity also rose just 0.1% during the month. However, upward revisions to prior data mean the February outcome is better than it appears at first glance. It also means that after two quarters of GDP contraction in Q3-2023 and Q4-2023, the U.K. economy very probably returned to positive growth at the start of 2024.



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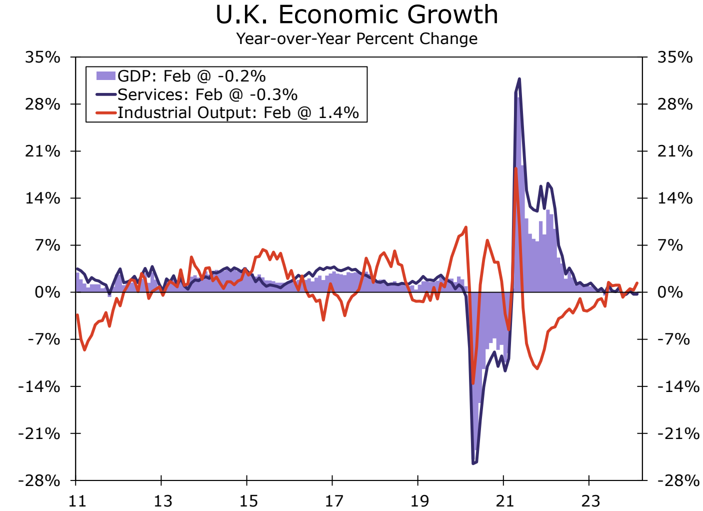
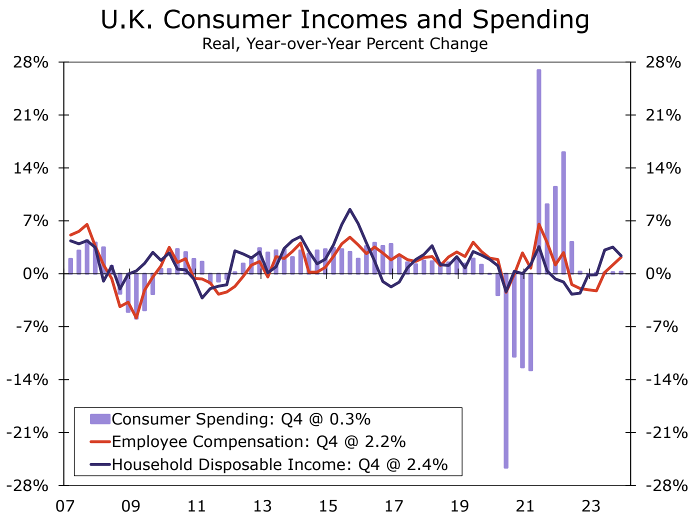


Source: Datastream and Wells Fargo Economics

Moreover, the details of the more comprehensive GDP data for Q4-2023 also contained some encouraging elements. While the headline figures revealed a second straight contraction in the economy, the details indicated a further strengthening in real household incomes amid decelerating inflation. U.K. real household disposable income growth firmed to 2.4% year-over-year in Q4, similar to real employee compensation which rose 2.2%. Both of those were well in excess of consumer spending, which rose just 0.3%. The household saving rate rose slightly to 10.2% of disposable income in Q4, and remains well above the levels prevailing immediately prior to the pandemic. Thus, even in the wake of the Bank of England's monetary tightening cycle and increased interest costs for households, we believe that trends in real household incomes should offer a positive impetus for consumer spending in 2024.

We are somewhat more cautious on the outlook for U.K. business investment, which rose strongly during 2022 but slowed somewhat during 2023, showing a gain of 2.8% year-over-year in Q4 last year. The same Q4 report on the U.K. economy showed the gross operating surplus of U.K. private non-financial corporates fell 7.5% year-over-year. That almost matched the largest decline seen during the pandemic. In addition, outside that pandemic-induced slump, the fall in the U.K. gross operating surplus was the largest since Q4-2009, surrounding the global financial crisis. A potentially cautious U.K. business outlook could be a headwind for investment spending in the quarters ahead. Taken together, we think an improving outlook for U.K. households and cautious outlook for U.K businesses should translate into a moderate overall pace of U.K. economic recovery. We have raised our forecast for 2024 U.K. GDP growth to 0.5%, from 0.3% previously.

Taken together, we believe a slower pace of disinflation could make BoE policymakers cautious about lowering policy interest rates prematurely, and nascent signs of U.K. economic recovery arguably also reduce the urgency for monetary easing. Against this backdrop, we now expect the BoE to keep its policy interest rate higher for longer, and **forecast an initial 25 bps BoE policy rate cut to 5.00% at the August monetary policy meeting.** That is later than our prior call for an initial rate cut in June. Reflecting still-elevated underlying inflation trends and an initially cautious approach from the BoE, **we expect the central bank skips September before delivering 25 bps rate cuts in November and December, for a cumulative 75 bps of rate cuts this year, which would see the policy interest rate end 2024 at 4.50%.** We expect a steady series of rate cuts to continue in early 2025, with 25 bps reductions at the February, March and May meetings. However, as the deceleration in underlying inflation plateaus and U.K. growth firms further, we see the pace of easing slowing thereafter, with 25 bps reduction at the August and November meetings. **Altogether, that would see a further cumulative 125 bps of BoE policy rate cuts in 2025, which would see the central bank's policy rate end next year at 3.25%.** Overall we expect the BoE to deliver modestly more easing than anticipated by market participants this year, and forecast noticeably more easing than expected by market participants next year. Over the medium-term, that could contribute to downward pressure on shorter-term U.K. bond yields, and see the pound underperform relative to many other G10 currencies over time.



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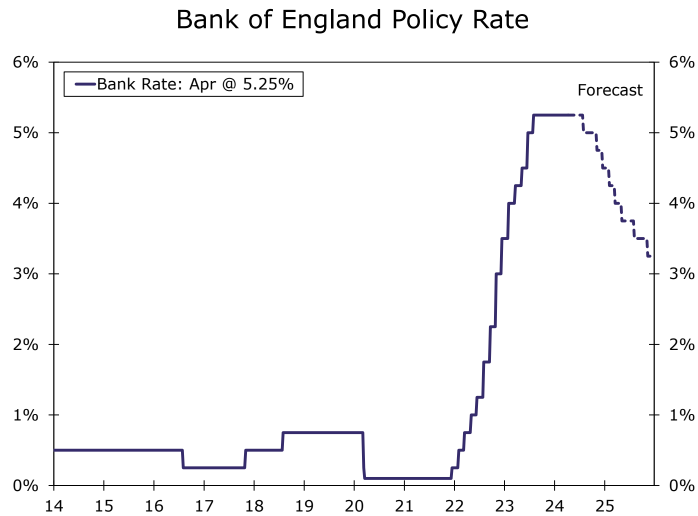

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