

# Special Coverage: Hawkish cut from split BoE

## Key takeaways

- ◆ The Bank of England (BoE) cut the bank rate by 0.25% at its August meeting. Following the cut, GBP weakened, and gilt yields fell. The most interest rate sensitive sectors rallied, with home builders up over 1% (at the time of writing). Broadly, UK markets outperformed those in Europe, which traded with a weak tone.
- ◆ The policy statement read as a “hawkish cut”, with more effort spent highlighting the upside risks to inflation than reasons for the cut. The BoE will continue to be data-dependent, and that upcoming growth and inflation data will play a pivotal role in guiding policy in the coming months.
- ◆ The rate cut emboldens our positive view of UK equities. The cut will send a signal to households that rates are heading lower, which will underpin the already improving sentiment and encourage households to spend. Investors should lock in yields while they can and not shy away from taking duration exposure in gilts or investment grade bonds, which we remain overweight. The rate cut will cap some of the upward pressure on GBP in our view.



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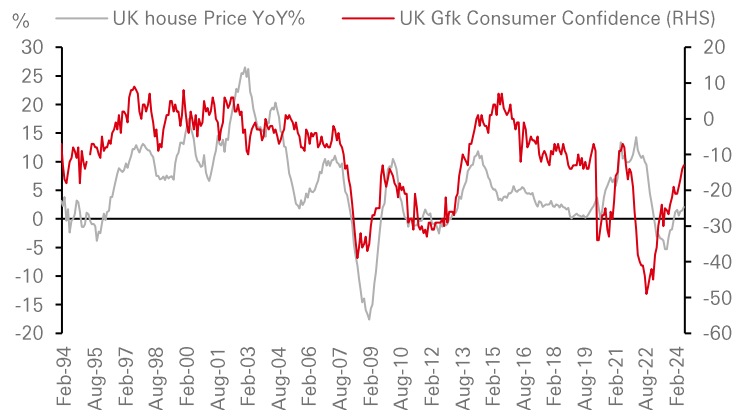
## What happened?

- By the finest of margins—a 5:4 committee vote—the BoE cut the bank rate by 0.25% to 5% at its August meeting. The scales were helped tipped by the new deputy governor, Clare Lombardelli, replacing Ben Broadbent in her first monetary policy meeting.
- The policy statement reads as a “hawkish cut”: Stronger-than-expected growth, the stickiness in services inflation, and the risk of higher goods prices as shipping costs have risen. The conclusion is that “there’s a risk that inflationary pressures from second-round effects will prove more enduring in the medium term”. The BoE is making it clear that they are still data-dependent, and that future policy would be set on a meeting-by-meeting basis.
- The divide between the BoE members is rooted in the varying opinions on how restrictive the current policy is. The slight majority felt that cooling labour market conditions reflect tight financial conditions that can be eased a little while remaining sufficiently restrictive. Others preferred to wait for more evidence that services inflation and wage growth are on a more sustained downward path.
- After the Bank of England lowered interest rates for the first time in over four years in this monetary policy cycle, the pound held losses against the dollar, and UK bonds added to earlier gains. GBP/USD fell by 0.8% to \$1.2755 immediately after the decision, whereas the UK 10-year yield slipped to 3.91% and the two-year peer fell to 3.76%.
- UK stocks edged higher after the cut was announced. Homebuilders were among the biggest gainers due to the expected boost to mortgage demand. Large-cap FTSE 100 and mid-cap FTSE 250 both gain 0.2%. Bloomberg UK Homebuilder Index gained 1.2%, with real estate stocks gaining as well at the time of writing.

## Investment implications

- We're more bullish on growth than the BoE and the consensus. This should feed through to earnings, especially those with a domestic focus. This cut to rates will likely be seen as concrete evidence of a turning point in borrowing rates and help support the already improving housing market. In the UK, house prices and consumer sentiment go hand-in-hand, which, in turn, also feeds into consumer spending. It's notable that the FTSE 250 didn't suffer on the GBP weakness, reflecting the better growth prospects, in our opinion.
- UK equities valuations are cheap. While the equity risk premium (which estimates the excess return for investing in equities over fixed income) has fallen, it remains attractive compared to European and US markets. They are also cheap compared to history. We remain overweight on UK equities.

### The rate cuts should help the housing market and consumer sentiment



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 1 August 2024.

- Relative political stability hasn't gone unnoticed by international investors, who have also taken note of the improved outlook, with a visible increase in investment in UK equities. Meanwhile, a decade-long rebalancing from pension funds away from equities should mean that these flows are met with less selling pressure. UK manufacturing PMI for July also rose to 52.1 from 50.9 after the election, which is its highest reading since July 2022. Output and new orders also increased at the quickest pace since February 2022.
- Our overweight on gilts remains. Investors should lock in yields while they can and not shy away from taking duration exposure in gilts. As and when the BoE started to cut, it would also shift longer-term rate expectations more towards our forecast of 3.5%. With this beginning of the rate cutting cycle, we expect the risks to rates to be skewed to the downside. This opens up a clear opportunity to put cash to work in gilts, locking in these higher rates, especially now, as yields are trading at attractive levels.
- It's also a good time to lock into investment grade bond yields. Credit spreads for investment grade bonds have fallen but are still trading around average levels. Given that rates have peaked, and UK growth is expected to be resilient, there is a worthwhile yield pick-up in strong investment grade names.
- The rate cut will cap some of the upward pressure on GBP, which is finding its feet as the Labour government looks to "reset" relations with the EU. Inflation-adjusted and against a basket of currencies, GBP is stronger than it looks. This should cap upward pressure on GBP, in our view, particularly as the markets look too dovish on US rate cuts.

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