

Special Coverage: BoE's Bailey opens door to June rate cut

Key takeaways

- ◆ The Bank of England (BoE) voted by 7-2 to hold the bank rate at its current level of 5.25%. Governor Bailey said that a rate cut in June was neither “ruled out nor planned”. As if this wasn’t enough to open the door for a June cut, he also said that it is “likely we will need to cut the bank rate” and will need to make monetary policy “less restrictive”.
- ◆ In the near term, we expect inflation to dip below 2%, providing further cover for the BoE to cut rates. Amid the volatility in rate expectations that have been caught up in the more hawkish Fed positioning, we have held on to our conviction that the BoE would cut in June. On the back of this BoE meeting, the market has shifted more towards our view, pricing in a 60% chance of a cut, according to Bloomberg.
- ◆ In our view, a June cut is still under-priced while the longer-term rate expectations have moved too far. This provides an opportunity to put cash to work in gilts, where yields are attractive. We also prefer investment grade bonds, which offer a further yield pick-up worth taking amid an improving economic backdrop. Within global equities, we have edged towards a more cyclical stance by first increasing European financials to overweight and then more recently, consumer discretionary but remain neutral overall on UK equities.



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What happened?

- The BoE voted by 7-2 to hold the bank rate at its current level of 5.25%. Swati Dhingra’s dovishness was a given, but Dave Ramsden’s call for a cut represents a shifting of the core internal committee members towards easier policy. There was an overriding sense of constructive ambiguity in the BoE’s policy summary. The BoE took note of the various indicators of the labour market and inflation but was reluctant to place any emphasis on a particular data point as defining forward monetary policy.
- Governor Bailey was a more open book. In the press conference, he said that a rate cut in June was neither “ruled out nor planned”. As if this wasn’t enough to open the door for a June cut, he also said that it is “likely we will need to cut the bank rate” and will need to make monetary policy “less restrictive”. He added that second round inflation effects are set to fade slightly more quickly than policymakers had previously thought. Verging on the return to forward guidance, Bailey stated that banks will likely need to cut rates “over the coming quarters” and more so than the market currently expects.
- Bailey also highlighted that inflation news has been encouraging and it is expected to fall close to BoE’s 2% target in the next couple of months. Though he stressed on the point that more evidence is needed on the inflation front that it will stay low for any dovish decision, he remained optimistic that things are moving in the right direction.

- Putting Bailey's comments aside, the BoE's two-year forecast for inflation was below target at 1.9% while the three-year inflation forecast was even lower at 1.6%. This is conditional on rates falling to less than 4% over the period because the BoE is forecasting an increasing build-up of economic slack. Swati Dhingra and Dave Ramsden feared that this slack would lead to inflation meaningfully undershooting the 2% target and voted to cut rates. Dave Ramsden is part of the internal members of the committee and his call for a cut represents a shifting of the core towards easier policy.

The BoE expects growing excess supply will bring inflation lower, despite more bullish GDP forecasts

	2024 Q2	2025 Q2	2026 Q2	2027 Q2
GDP	0.2 (0.1)	0.9 (0.6)	1.2 (1.0)	1.6
CPI inflation	2.0 (2.0)	2.6 (2.7)	1.9 (2.2)	1.6
Unemployment rate	4.3 (4.4)	4.6 (4.8)	4.8 (5.0)	4.8
Excess supply/Excess demand	-¼ (-¼)	-¾ (-¾)	-1¼ (-1)	-1
Bank Rate	5.2 (5.0)	4.5 (3.7)	4.0 (3.3)	3.7

Source: Bank of England, HSBC Global Private Banking and Wealth, as at 9 May 2024. Forecasts are subject to change.

- With the BoE's medium-term forecasts providing ammunition for a cut, why the hesitation? Firstly, inflation is expected to tick up towards 2.5% thanks to some persistence in services inflation. Secondly, wage growth remains a little too high, and the moving parts that translate wage growth to inflation aren't clear to the BoE.
- Also, with the UK coming out of a very slight recession and the housing market showing some tentative signs of picking up, they can afford to gather a little more data before taking the plunge.
- Noted there's an improvement, but rate cuts are still needed. Lending has improved modestly, but annual growth is still scraping along the bottom. Also, there has been a pick-up in insolvencies, although broader non-performing loans are comfortingly low. Higher rates have clearly hurt some, but the broader economy has proved more resilient than many feared.
- Thanks to a fall in the price cap for energy, we forecast inflation falling below 2% for this quarter. Market expectations are now slightly siding with a June cut, in line with our thinking.

Investment implications

- Both the FTSE 100 and FTSE 250 hit an intraday high after the BoE's decision and the dovish tone from Governor Bailey. UK homebuilders rose to their highest levels in over two years as the BoE moved closer to a rate cut.
- Typically, the FTSE 250 tends to under-perform when GBP weakens. However, if this is driven by falling rate expectations rather than a deterioration of the UK's outlook, this might not be a showstopper for a more positive UK domestically focused equity view. This was reflected by our recent upgrade of the financial sector in Europe, which takes advantage of an improved domestic outlook but with less sensitivity to GBP. We remain selective but note the upside risk to UK smaller-cap equities.
- The FTSE 100 is loaded with more defensive stocks, such as healthcare, and value stocks such as energy and materials. Given that tactically we have turned a little more positive on the global economic cycle and place little emphasis on a return to the low growth, high inflation climate, we see no clear incentive to turn more positive on the UK large caps, sticking with our neutral view.
- One of the most striking opportunities is the longer end of the UK gilt curve. Market expectations are strikingly different from five years ago. Admittedly, five years ago, "secular stagnation" was the dominant narrative, and ultra-low rates were the consensus expectation. Yet the pricing of a low in policy rates of 3.6% in 2028 is a leap too far in expectations for us in thinking of where policy rates can sustainably be. This opens up a clear opportunity to put cash to work in gilts, locking in these higher rates – there is also the opportunity to earn a total return in excess of yields if these market rate expectations shift lower, as we expect them to.
- As we expect the BoE to cut in June while the Fed should cut in September, this puts downside risk on the yield differential, which in turn, puts downward pressure on GBP. Therefore, there is a window of opportunity to invest in a more global, diversified portfolio ahead of the upcoming expected policy divergence.

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