Sterling Slides as UK Economic Outlook Deteriorates

Last week, the Bank of England Monetary Policy Committee voted to hike rates as expected by 25bps to 1%. However, the meeting minutes showed deep divisions amongst members as a period of stagflation beckons for the UK economy. There were a number of surprises in the Committee's deliberations. Three of its nine members voted for a 50bps hike, which was more than expected.

However, it also seems from the minutes that some members gave consideration to leaving rates unchanged. Indeed, at the previous meeting in March, one member voted to keep rates on hold. Furthermore, while most Committee members were happy with the guidance that some degree of further tightening in monetary policy might still be appropriate, some others judged such guidance was not apt at this juncture given that the risks around activity and inflation were more evenly balanced.

The economic backdrop is becoming increasingly challenging, which is making monetary policy decisions all the more difficult. The Bank revised its near-term inflation forecasts sharply upwards. It now expects inflation to rise above 10% in the final quarter of the year and still be well above its 2% target, at 3.5%, by the end of next year. This would seem grounds for a further significant tightening of policy as envisaged by the markets, which see UK rates climbing to 2.1% by end 2022 and above 2.5% in late 2023.

However, the Bank's forecasts, which are conditioned on current market interest rate expectations, also foresee a mild recession and a period of stagnation for the UK economy, with GDP projected to contract by 0.25% in 2023 and grow by just 0.25% in 2024. As a result, the unemployment rate is seen as climbing from 3.6% to 5.5% over the next three years. Crucially though, the Bank is projecting that inflation will fall well below target to 1.3% by 2025, which argues against the degree of tightening currently priced in by markets.

Meanwhile, the bank says if interest rates are held constant at 1% over the next three years, growth is materially stronger and inflation would fall to 2.2% in 2025, which is slightly above target. This suggests that a further modest tightening of monetary policy is required to return inflation to target.

The Bank acknowledges there is considerable uncertainty around its economic forecasts. What is clear, though, is that a period of very high inflation and a marked weakening of growth, if not outright recession, lies in store for the UK economy. The economy is facing multiple headwinds, including a fall of 1.75% in real household disposable income this year, a deteriorating net external trade position following Brexit, as well as a tightening of monetary and fiscal policy.

The Bank seems strongly of the view that inflation will fall sharply from the end of this year onwards. As such, given the risks facing the economy and the interest rate guidance from the Monetary Policy Committee, the markets look to be pricing in excessive policy tightening. If the economy deteriorates to the extent anticipated by the Bank, we would not be surprised if rates peaked at 1.5-1.75% later this year. Sterling is taking note of all this, losing ground recently, with the euro rising from 83p to near 86p.

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