IE

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Global investment event
Bank of England hikes rates

- At the Bank of England's (BoE) August meeting, interest rates were raised by 25 basis points to 0.75% in an unanimous vote
- The BoE painted a marginally more bullish view of the UK economy. They also emphasised that future UK interest rate hikes will be "gradual and limited"
- There are major question marks over the extent to which the BoE will be able to tighten policy further, especially given Brexit related uncertainty

Our views

Our core asset class views are unchanged. We remain neutral UK equities amid downside risks to UK economic growth. We also retain our underweight positioning in UK gilts and corporate bonds

The Bank of England hikes interest rates

The Bank of England's (BoE) Monetary Policy Committee (MPC) hiked UK interest rates (also known as "Bank Rate") by 25 basis points to 0.75% at its August meeting. The decision was widely expected by investors following recent communication from the MPC and a recent rebound in UK activity data following a weak Q1.

The decision was unanimous across all nine members of the committee. The lack of dissent surprised some investors, given that recent UK inflation data have been lower-than-expected, and downside risks to the outlook have risen amid stalling Brexit negotiations and global trade tensions.

Overall, this leaves Bank Rate at its highest level since early 2009, although still well below levels prevailing before the global financial crisis (GFC) of 2007-9 of around 5%.

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The details…

In the Bank's August Inflation Report, the MPC painted a marginally more bullish outlook for the UK economy than in the last report in May. GDP growth is now forecast to be 1.4% in 2018 (unchanged), 1.8% in 2019 (versus 1.7% previously) and 1.7% in 2020. Meanwhile, unemployment forecasts were also nudged slightly lower, to 3.9% over the forecast period. Inflation is now expected to end this year at 2.3% (2.2% previously), 2.2% in 2019 (up from 2.1%) and 2.0% in 2020 (unchanged).

These new forecasts may be interpreted as a hawkish signal to the market. However, they are based on market-derived estimates of future UK interest rates that are lower than assumed in the May report. Furthermore, the bulk of the inflation uptick is due to recent declines in the British pound (raising import costs), rather than domestically-generated pressures.

At the post-meeting press conference, BoE Governor Mark Carney failed to comment on whether current market expectations of future UK interest rates (two rate hikes in the next three years) are appropriate for the UK economy. His comment that "policy needs to walk, not run, to stand still," along with an acknowledgment that policy could loosen in the event of a hard Brexit, helped send the British pound (GBP) lower against the US dollar (USD) over the day.

Market considerations

The Bank of England continues to emphasise that future UK interest rate hikes will be "gradual and limited". This policy adjustment does not herald the beginning of a significant rate hiking cycle similar to the US Federal Reserve's trajectory since 2015. At this meeting, the Bank of England also released their estimate of the long-run neutral interest rate, where policy is neither contractionary nor expansionary, which at 2-3% is below the typical UK interest rate seen before the GFC.

There are also major question marks over the extent to which the BoE will be able to tighten policy further in the coming quarters, given downside risks to UK growth. Also, Carney alluded to the possibility of a hard Brexit (which could see the UK leave the EU without a negotiated withdrawal treaty), adding to pressure on GBP.

The MPC has also a fairly bullish outlook for wage growth, predicated on the basis of a tight UK labour market. If this does not develop as expected, realised inflation may be lower than the bank currently expect.

Overall, our investment views are unchanged. Current valuations are consistent with a neutral stance on **UK equities**, in our view, with the UK economy likely to remain a relative underperformer among developed markets. We prefer emerging markets, Japanese and eurozone equities which offer higher prospective risk-adjusted returns.

Meanwhile, for **UK gilts and sterling (GBP) corporate bonds**, we believe current valuations are stretched, and retain our underweight positioning.

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