Special Coverage:
Bank of England continues with a slow and steady approach to easing

Key takeaways

- The Bank of England (BoE) maintained the Bank Rate at 4.5%, carefully balancing the current above-target inflation against slowing economic growth and waiting for a safer moment to move.
- As the BoE looks forward, they have more reasons to cut rates: growth is slowing, and their broader measures of the labour markets are pointing to easing pressure on wage growth. If it wasn't for the current levels of inflation, we believe the BoE would be cutting rates faster. The eventual hump in inflation should pass in Q3 after peaking at around 3.75%, according to the BoE's forecasts.

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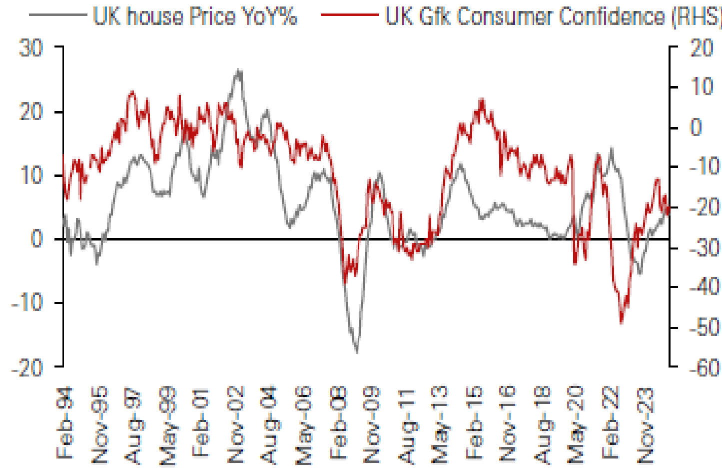
- There is also the possibility that Chancellor Reeves may cut government spending, so that she sticks to the fiscal rules. The housing market is unlikely to roar higher, implying a continuation in consumer behaviour that has prioritised saving over spending. This suggests a neutral outlook for UK equities in the coming months. The combination of high yields, tax advantages, strong reinvestment demand, and economic uncertainty makes gilts an appealing investment.

What happened?

- The BoE's MPC voted 8-1 to maintain the Bank Rate at 4.5%, continuing the restrictive monetary policy stance. Only one member (Swati Dhingra) dissented and argued for a 0.25% cut.
- The committee emphasised that interest rates must remain high until inflation risks are sufficiently reduced. High labour costs, which continue to put pressure on domestic prices, remain a key driver for inflation. Additionally, supply chain disruptions and global trade uncertainty are influencing import prices. The monetary policy decision signalled that while the UK is making progress on inflation, risks remain, and interest rates will stay high for now for the inflation to fall sustainably to 2%.
- The UK job market is proving to be more resilient than expected, with wages continuing to rise at a steady pace. The latest data from the Office for National Statistics shows that average pay (excluding bonuses) grew by 5.9% in the three months to January. Payroll data for February revealed an increase of 21,000 new jobs, defying expectations of a decline. With inflation still a concern, the BoE seems hesitant to lower rates too soon, fearing that strong wage growth could keep prices elevated for longer.
- Our earnings indicator, though moving a bit up, is still not as decisive as other data like retail sales, consumer confidence and PMIs, which all remain muted. Businesses seem hesitant to hire, largely because of the uncertainty in the economy. In the UK, this has led to a sharp drop in staffing levels, as companies are feeling the pressure of weaker demand, higher minimum wages, and increased national insurance costs. While the services sector hasn't been hit directly by tariffs yet, rising prices are still squeezing their margins.

- UK banks typically run with cost-income ratios of around 55-65%. Normally, when revenues rise, so do expenses. However, these banks are now seeing a growing gap between income and expense growth, thanks to factors like automation and AI, as more than half of their costs come from staff and operations. The positive trend in household deposits should further contribute to earnings.
- In the UK, house prices and consumer sentiment tend to go hand-in-hand, which, in turn, also feeds into consumer spending. The consumer confidence, which recovered slightly in February, remains in negative territory. In 2025, those who took advantage of ultra-low interest rates and tax breaks are now facing a financial reality check. Many real estate investors who secured five-year fixed-rate mortgage deals at the height of the housing boom are now seeing those deals expire, leaving them exposed to significantly higher borrowing costs.

Consumer confidence remains muted in the UK



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 20 March 2025.

- While the UK and the US have a relatively balanced trade relationship, there is a risk of Mr. Trump's policies hitting UK exports hard, especially if he included VAT-related tariffs. There is also a concern of selectively targeted tariffs on industries with little US domestic production, making UK goods more expensive and less competitive. The sectors that are most at risk include pharmaceuticals, optical and medical equipment, industrial machinery, and automotive goods. These tariffs could put pressure on UK exports and create wider economic consequences.

Investment implications

- UK gilts remain an attractive long-term investment as the BoE maintains a cautious approach to cutting rates. They have become increasingly attractive due to a combination of high yields, favourable tax conditions, and broader economic uncertainty.
- In recent months, purchases of UK government bonds have surged, driven by the all-time high yields that gilts are currently offering. With interest rates staying elevated, we think that investors should take the opportunity to lock in higher returns for longer. Uncertainty around global economic conditions and central bank policies further adds to the allure. A batch of low-coupon gilts matured in late January has also freed up significant cash and many of the investors have chosen to reinvest in gilts.
- On the equity side, the possibility that Chancellor Reeves may cut government spending, the signs of a slowdown in the UK housing market and the potential impact of US tariffs warrant a neutral stance on UK equities.

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