

## BoE To Pave Way for Feb Rate Hike

### Amy Yeo

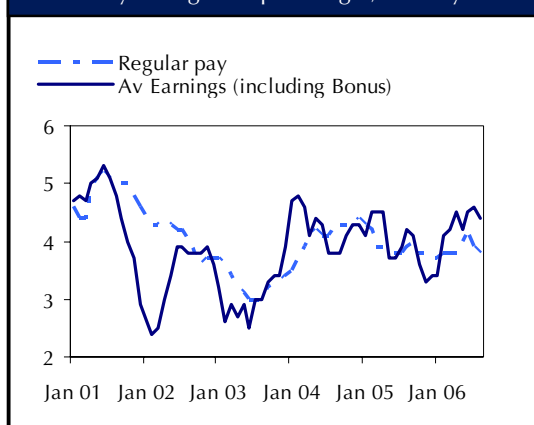
(65) 6539 3549  
Amy.YeoHF@UOBgroup.com

### Jimmy Koh

(65) 6539 3545  
Jimmy.KohCT@UOBgroup.com

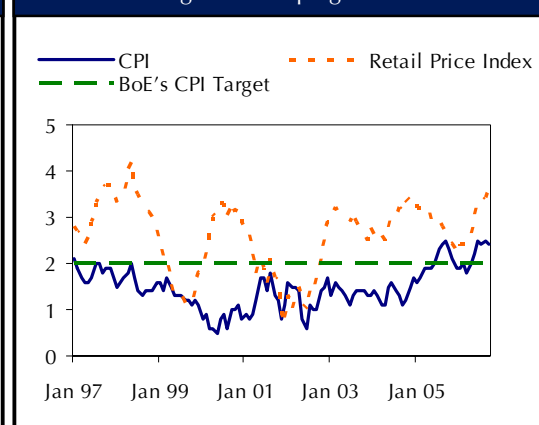
- MPC Meeting This Week:** BoE holds its 2-day MPC meeting over Wed-Thurs, where the CB is widely expected to leave rates unchanged at 5%. Consensus is for the MPC to maintain the Dec's "wait and see" bias, with the CB preferring to have more time to assess the impact of past rate hikes. With steady rates largely a non-event, minutes of the Jan MPC meeting (due 24th Jan) would be important in paving the way for a Feb rate hike. In current tightening cycle, the MPC appears to have a preference towards lifting interest rates coinciding with the release of the quarterly Inflation Report (due a week after Feb MPC rate decision), perhaps as the latter provides greater clarity on the growth and inflation trajectory.
- BoE Rhetoric:** Minutes of the Dec MPC meeting showed a unanimous 9-0 vote to keep the repo rate steady at 5%. Although the Dec minutes revealed a divergence in views amongst the committee members (most viewing risks to inflation were tilted towards the upside, while others pointed out downside risks to growth), the MPC on balance felt more time was needed for a clearer assessment of economic conditions. Come Jan MPC meeting over Wed-Thurs, expectations are towards BoE maintaining a "wait and see" bias. Nonetheless, the BoE is likely to raise increasing concerns over acceleration in house prices, high credit level as well as risks of 2nd round effect on wages. Hawkish CB rhetoric should set the stage for the BoE to deliver a 25bps rate hike to 5.25% in Feb, with potential towards more tightening moves in 2007.
- Economic Data Supportive of Higher Interest Rates:** UK economic data has been mixed. Although consumer spending and manufacturing data revealed signs of sluggishness, overall economic growth was robust, with Q3 GDP rising 2.9% vs 2.7% in Q2. Domestic growth is also projected to remain around trend over next 2 years. Acceleration in house prices (despite past rate hikes) and pick up in mortgage equity withdrawal (MEW) are also likely to translate into firmer consumer spending in 2007. MEW picked up to 5.4% of post-tax income in Q3 compared to 5.1% in Q2, as increase in house prices encouraged further wealth extraction from house values to finance current expenditure. Despite the 50bps increase in interest rates in 2006, house prices rose 9.9% in Dec vs 9.6% in Nov, according to UK lender Halifax. In addition, the BoE appears increasingly concerned over ample liquidity. Recent M4 data (annual growth) was up 14.4%, a good indication of accommodative conditions posing upside risks to price stability.

Risks of Any Strong Pickup in Wages, a Worry for BoE



Source: BoE, UOB

Above Target CPI Keeping BoE Hawkish



Source: BoE, UOB

- **Inflation pressures Building:** Amid acceleration in property market, rise in utility bills and high credit levels exerting inflationary pressure, CPI rose 2.7% in Nov from 2.4% in Oct, persisting above the BoE's inflation target of 2%. Indeed, according to BoE's quarterly Nov survey, median inflation expectations for year 2007 climbed to 2.7% compared to 2.5% in the survey done in Aug. The BoE is likely to keep a close eye for any further pick up in inflation expectations pushing up wage expectations.
- **BoE to Anchor Inflation Expectations:** Watch for BoE's increasing wariness over any significant pick up in wages. Thus far, average wages remained benign – influx of migrant labour especially from Eastern Europe have kept wages low, at the same time restraining locals from demanding higher wages. However, with corporates (in particular oil sector firms) registering robust profits over 2006, there are increasing calls among trade unions for higher wages this year. In addition, the RPI (a measure for many wage settlements) jumped 3.9%, marking highest jump in 8 years. Income Data Services also reported median wage settlements rose 4% in Jan, higher than the average 3% over past few years, suggesting slight recovery in households' earning power this year. At the Jan MPC meeting, the BoE is likely to highlight warnings over higher interest rates to anchor inflation expectations even as wage talks take place early 2007.
- *In our view, we expect the BoE to deliver a 25bps rate hike to 5.25% in Feb, with risks towards further hikes in 2007.*

---

Disclaimer: This analysis is based on information available to the public. Although the information contained herein is believed to be reliable, UOB Group makes no representation as to the accuracy or completeness. Also, opinions and predictions contained herein reflect our opinion as of date of the analysis and are subject to change without notice. UOB Group may have positions in, and may effect transactions in, currencies and financial products mentioned herein. Prior to entering into any proposed transaction, without reliance upon UOB Group or its affiliates, the reader should determine, the economic risks and merits, as well as the legal, tax and accounting characterizations and consequences, of the transaction and that able to assume these risks. This document and its contents are proprietary information and products of UOB Group and may not be reproduced or otherwise.

---