

Commentary by MUFG Corporate Markets on The Economy and Interest Rates

UK Economy

UK inflation has proved somewhat stubborn throughout 2024/25. Having started the financial year at 2.3% y/y (April), the CPI measure of inflation briefly dipped to 1.7% y/y in September before picking up pace again in the latter months. The latest data shows CPI rising by 2.8% y/y (February), but there is a strong likelihood that figure will increase to at least 3.5% by the Autumn of 2025.

Against that backdrop, and the continued lack of progress in ending the Russian invasion of Ukraine, as well as the potentially negative implications for global growth as a consequence of the implementation of US tariff policies by US President Trump in April 2025, Bank Rate reductions have been limited. Bank Rate currently stands at 4.5%, despite the Office for Budget Responsibility reducing its 2025 GDP forecast for the UK economy to only 1% (previously 2% in October).

Moreover, borrowing has becoming increasingly expensive in 2024/25. Gilt yields rose significantly in the wake of the Chancellor's Autumn Statement, and the loosening of fiscal policy, and have remained elevated ever since, as dampened growth expectations and the minimal budget contingency (<£10bn) have stoked market fears that increased levels of borrowing will need to be funded during 2025.

The table below provides a snapshot of the conundrum facing central banks: inflation pressures remain, labour markets are still relatively tight by historical comparisons, and central banks are also having to react to a fundamental re-ordering of economic and defence policies by the US administration.

| | UK | Eurozone | US |
|--------------------------|-------------------------|--------------------------|--------------------|
| Bank Rate | 4.50% | 2.5% | 4.25%-4.5% |
| GDP | 0.1%q/q Q4 (1.1%y/y) | +0.1%q/q Q4 (0.7%y/y) | 2.4% Q4 Annualised |
| Inflation | 2.8%y/y (Feb) | 2.3%y/y (Feb) | 2.8%y/y (Feb) |
| Unemployment Rate | 4.4% (Jan) | 6.2% (Jan) | 4.1% (Feb) |

The Bank of England sprung no surprises in their March meeting, leaving Bank Rate unchanged at 4.5% by a vote of 8-1, but suggesting further reductions would be gradual. The Bank of England was always going to continue its cut-hold-cut-hold pattern by leaving interest rates at 4.50% but, in the opposite of what happened at the February meeting, the vote was more hawkish than expected. This suggested that as inflation rises later in the year, the Bank cuts rates even slower, but the initial impact of President Trump's tariff policies in April 2025 on the financial markets underpin our view that the Bank will eventually reduce rates to 3.50%.

Having said that, the Bank still thinks inflation will rise from 2.8% in February to 3¾% in Q3. And while in February it said "inflation is expected to fall back thereafter to around the 2% target", this time it just said it would "fall back thereafter". That may be a sign that the Bank is getting a bit more worried about the "persistence in domestic

wages and prices, including from second-round effects". Accordingly, although we expect a series of rate cuts over the next year or so, that does not contradict the Bank taking "a gradual and careful" approach to cutting rates, but a tepid economy will probably reduce inflation further ahead and prompt the Bank to cut at regular intervals.

From a fiscal perspective, the increase in businesses' national insurance and national minimum wage costs from April 2025 is likely to prove a headwind, although in the near-term the Government's efforts to provide 300,000 new homes in each year of the current Parliament is likely to ensure building industry employees are well remunerated, as will the clamp-down on immigration and the generally high levels of sickness amongst the British workforce. Currently wages continue to increase at a rate close to 6% y/y. The MPC would prefer a more sustainable level of c3.5%.

As for equity markets, the FTSE 100 has recently fallen back to 7,700 having hit an all-time intra-day high 8,908 as recently as 3rd March. The £ has also endured a topsy-turvy time, hitting a peak of \$1.34 before dropping to \$1.22 in January and then reaching \$1.27 in early April 2025.

USA Economy

Despite the markets willing the FOMC to repeat the rate cut medicine of 2024 (100 basis points in total), the Fed Chair, Jay Powell, has suggested that the Fed. Funds Rate will remain anchored at 4.25%-4.5% until inflation is under control, and/or the economy looks like it may head into recession as a consequence of President Trump's tariff policies.

Inflation is close to 3% and annualised growth for Q4 2024 was 2.4%. With unemployment just above 4%, and tax cuts in the pipeline, the FOMC is unlikely to be in a hurry to cut rates, at least for now.

EZ Economy

The Eurozone economy has struggled throughout 2024 and is flat lining at present, although there is the promise of substantial expenditure on German defence/infrastructure over the coming years, which would see a fiscal loosening. France has struggled against a difficult political backdrop, but with a large budget deficit it is difficult to see any turn-around in economic hopes in the near-term.

With GDP currently below 1% in the Euro-zone, the ECB is likely to continue to cut rates, although the headline inflation rate is still above 2% (2.3% February 2025). Currently at 2.5%, a further reduction in the Deposit Rate to at least 2% is highly likely.