Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 20 3465 2672

UK: BOE INFLATION REPORT PREVIEW - EARLY SIGNS OF HAWKISHNESS?

Berenberg Macro Flash

With some words of Brexit-related caution, the Bank of England (BoE) may surprise with a more hawkish tone at tomorrow's Inflation Report as it revises up its near-term growth forecast and highlights growing underlying inflationary risks. The shift could come either in the form of more hawkish forward guidance or some MPC members voting in favour of bringing an end to the corporate bond purchase program sooner than planned.

BALANCING CRITICAL RISKS

The UK economy is performing well. Demand growth is strong and confidence is resilient, while investment intentions, though they have eased a little since the Brexit vote, mostly remain healthy. Brexit did not have a major effect on the UK economy in 2016. It looks likely to be no more than a modest demand-side shock in 2017 and 2018. There is a growing argument for tighter monetary policy in the UK. After almost eight years of strengthening their balance sheets, households started to gear up in 2016. With its large balance sheet and negative real rate policy the BoE risks encouraging a return to debt-driven growth, only to be followed by a bust later on.

However, the UK still faces some serious downside risks. The economy has avoided the potholes so far. But if Brexit uncertainty begins to act as a bigger drag on spending and investment, or if the housing market suddenly soured, or if the rise in inflation was more serious than currently anticipated, the economy's current strong momentum could turn on a sixpence. So far, none of these risks looks as if they will materialise. But any of them has the potential to endanger the expansion. The BoE has a tough job of navigating this trade-off. The longer the economy continues to surprise to the upside, the greater the balance of probability tilts towards tighter monetary policy.

Could a policy U-turn put the BoE's credibility in question? No. Instead, waiting too long before changing policy to a more appropriate setting would risk the BoE falling behind the curve, which could create major risks for the sustainability of the expansion in the long-run.

GDP UP, UNEMPLOYMENT DOWN, BUT WHAT ABOUT INFLATION?

The UK economy has performed solidly since the last Inflation Report in November. The minutes from the most recent MPC meeting in December showed the committee anticipated that growth would slow from 0.5% qoq in Q3 to 0.4% qoq in Q4. Revised GDP data showed the economy grew at a strong and stable pace of 0.6% qoq in the final three quarters of 2016. Soft data, including PMIs and consumer confidence, suggest the economy has carried significant momentum into 2017. The resilient demand will likely lead the BoE to revise up its forecast for growth in 2017 from 1.4% yoy, closer to our call of 1.8%, while leaving the forecasts for 2018 and beyond largely unchanged. The stronger growth outlook will likely cause the BoE to lower its expected path for unemployment compared to the November forecasts.

At c$56 per barrel, the current price of oil is broadly in line with BoE's November assumption. Meanwhile, trade weighted sterling has appreciated since the bank's last forecast round. In the past, the BoE's forecast for sterling has shifted in line with the trend between Inflation Reports. That the BoE will likely raise its sterling forecast implies less inflationary pressure through the exchange rate in the medium-term. However, stronger expected demand growth relative to potential supply growth will probably raise the BoE's assessment of underlying inflationary pressure. In the past, the BoE has tended to look through transitory forces on inflation such as exchange rates or commodity prices, focusing instead on underlying domestic factors. While the BoE's inflation outlook may not change all that much, that the forthcoming rise could be driven more by underlying forces than before could encourage the BoE to take a more hawkish tone than before.

POLICY OUTLOOK – NEUTRAL WITH RISKS TILTED TOWARD A HIKE IN LATE 2017

Barring an unexpected and sharp economic downturn, the next move for the BoE is likely to be up, eventually. When the hike comes depends upon the MPC's judgement of demand and supply over the medium-term. In our base case, we expect the BoE to stay put for the foreseeable future as growth slows and Brexit uncertainty remains elevated. But in an upside surprise scenario, stronger global and UK growth could lead to inflation overshooting the BoE's 2% target rate by more and for longer than the ultra-dovish BoE would like to tolerate. If the stronger outcomes for growth and inflation occurred with a continued rise in households' appetite for debt, the BoE could thus begin to tilt from its current neutral stance to a more hawkish one – a first rate hike in late 2017 could be one of the surprises of the year. We see a 30% chance of that.

Any progress towards a first hike will be very gradual. As a first step, the BoE could end its purchases of corporate bonds or alter its guidance from recent minutes to acknowledge the rising risk of underlying inflationary pressure. That would involve a change in the MPCs neutral guidance from recent minutes, 'Monetary policy could respond, in either direction, to changes to the economic outlook as they unfolded to ensure a sustainable return of inflation to the 2% target'.

PREDICTIONS FOR THE IMMEDIATE POLICY DECISION OF THE FEBRUARY MPC MEETING

(1) We expect the MPC to vote unanimously in favour of keeping the bank rate at 0.25%.
(2) We do not expect any MPC members to vote in favour of extending the £60 billion of UK government bond purchases (over a six month period) announced in August 2016.
(3) Some MPC members could vote in favour of ending the purchases of sterling non-financial investment grade corporate bonds – £10bn planned over an 18 month period, announced in August 2016. This could mean opting to complete the program before the £10bn target is reached.

GDP (yoy %)	2016	2017	2018	2019
November Inflation Report	2.2	1.4	1.5	1.6
Berenberg	2.0	1.8	1.6	

CPI inflation (yoy %)	2016 Q4	2017 Q4	2018 Q4	2019 Q4
November Inflation Report	1.3	2.7	2.7	2.5
Berenberg	1.2	2.8	2.3	

LFS unemployment rate (%)	2016 Q4	2017 Q4	2018 Q4	2019 Q4
November Inflation Report	4.9	5.4	5.6	5.6
Berenberg	4.8	5.2	5.2	

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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
Kallum.pickering@berenberg.com