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

BOE: RATE HIKES – A QUESTION OF WHEN, NOT IF

Berenberg Macro Flash

Markets are still too dovish according to the BoE
Edging towards a rate hike: The Bank of England has not changed its tone by much. Similar to the message which the Monetary Policy Committee (MPC) had put out in May, the key piece of forward guidance which the MPC provided in the minutes of its August meeting today was that, 'if the economy were to follow a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by the yield curve underlying the August projections'. With two dissenting MPC members – known hawks Ian McCafferty and Michael Saunders - and the modest downgrade to the BoE's near-term forecast for real GDP, the August Inflation Report was in line with our expectations – see 'BoE preview – cautiously hawkish'. We therefore maintain our call that the BoE will deliver a first hike of 25bps upon publishing the November 2017 Inflation Report. As our base case we expect four hikes between now and the end of 2019, two more than the market was pricing in at the time of the August report.

BoE reduces its estimate of potential growth
As we have consistently argued over the past year, thanks to Brexit, slower growth is the new normal for the UK. Today the bank downgraded its forecast for real GDP growth in the near-term to 1.7% (1.9%), 1.6% (1.7%) and 1.8% for 2017, 2018 and 2019, respectively. The BoE has also lowered its estimates of potential growth, stating that growth picks up to 'just above its reduced potential rate over the balance of the forecast'. Although the BoE did not state its new estimate of potential growth explicitly, its language implies that it is within the range of 1.6-1.8%. We expect Brexit to reduce trend growth to 1.8% per year from 2.2% previously. This indicates that the BoE will now require less demand growth than before at full employment before it begins to see risks of rising underlying inflation pressure.

Presumably, the reduced forecast for potential growth is driven by the bank's assumptions about Brexit – which will weaken the UK's trading arrangements with the EU, its biggest market - and its reduced outlook for the stock of capital relative to employment. The BoE now expects 'the level of investment in 2020 ...to be 20% below the level which the MPC had projected just before the referendum'. The lower near-term real GDP forecast for 2017 is mainly due to the weaker than expected growth in H1. Within the growth mix, the BoE has lowered its forecast for real household consumption a little due to a weaker wage outlook, despite a reduced unemployment forecast. But the lower consumption growth is offset by a modest upward revision to its outlook for business investment and exports.

BoE still on course for a November hike, but risk of a delay has risen
In line with its modest changes compared to its May outlook, the BoE broadly left its inflation forecasts unchanged. Inflation is set to remain above the BoE's 2% target all the way to late 2020 when the BoE's forecast ends. In his opening statement, Governor Carney said that 'the Committee judges that, given the assumptions underlying its projections ... some tightening of monetary policy would be required in order to achieve a sustainable return of inflation to target.' This suits our call for a modest tightening of monetary policy over the medium-term.

However, in the August minutes, the BoE removed a key comment from the June minutes 'Overall, the degree of spare capacity in the economy appeared limited but, at the same time, the inflation overshoot relative to the target could be more pronounced than previously thought. This lessened the trade-off that the MPC was required to balance and, all else equal, reduced the MPC's tolerance of above-target inflation. The Committee discussed the appropriate response of monetary policy.' That the BoE's inflation forecast is largely unchanged suggests the committee, on balance, has dropped this risk from its outlook. As a result, the bank's perceived risk it could fall behind the curve with rate hikes is probably lower than in June. As the BoE continues to expect to tighten policy, we take this change as a potential risk that the first hike might be later than we currently expect. While we still look for a first hike in November, we acknowledge some risk that the BoE waits until the first half of 2018.

Policy summary (quoted from the August MPC minutes)
The Governor invited the Committee to vote on the propositions that:

- Bank Rate be maintained at 0.25%;
- The Bank of England maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion;
- The Bank of England maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion;
- The drawdown period for the Term Funding Scheme close on 28 February 2018, as originally envisaged.

Regarding Bank Rate, six members of the Committee (the Governor, Ben Broadbent, Jon Cunliffe, Andrew Haldane, Silvana Tenreyro and Gertjan Vlieghe) voted in favour of the proposition. Two members (Ian McCafferty and Michael Saunders) voted against the proposition, preferring to increase Bank Rate by 25 basis points. The Committee voted unanimously in favour of the other propositions.

See a summary of Bank of England and Berenberg forecasts on the next page.

GDP	2017	2018	2019
Bank of England Aug 2017	1.7	1.6	1.8
Bank of England May 2017	1.9	1.7	1.8
Berenberg estimates	1.7	1.6	1.7

Source: BoE, table 5.B, page 32, August Inflation Report 2017 Berenberg.

CPI inflation	2017 Q3	2018 Q3	2019 Q3	
Bank of England Aug. 2017	2.7	2.6	2.2	2.2
Bank of England May 2017	2.7	2.6	2.2	
Berenberg estimates	2.7	2.6	2.2	

Source: BoE, table 5.B, page 32, August Inflation Report 2017 Berenberg.

LFS unemployment rate	2017 Q3	2018 Q3	2019 Q3	
Bank of England Aug. 2017	4.4	4.5	4.5	4.4
Bank of England May 2017	4.7	4.7	4.6	
Berenberg estimates	4.5	4.4	4.4	

Source: BoE, table 5.B, page 32, August Inflation Report 2017 Berenberg.

Bank rate	2017 Q3	2018 Q3	2019 Q3	
Bank of England Aug. 2017	0.2	0.5	0.6	0.8
Bank of England May 2017	0.2	0.3	0.4	
Berenberg estimates	0.5	1.0	1.25	

Source: BoE, table 5.B, page 32, August Inflation Report 2017 Berenberg.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3465 2672
www.berenberg.com
kallum.pickering@berenberg.com