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BOE: A MAY RATE HIKE IS VERY LIKELY

Berenberg Macro Flash

Ready for another rate hike? With the knowledge that the market is increasingly pricing in another 25bps rate hike in May, today the BoE had an opportunity to confirm or squash this expectation. That the BoE did not seek to shift the market pricing away from May, which showed a c50% chance of a hike before today's meeting, is a de facto confirmation that the bank is satisfied with the way the market views the timing of the next hike. Since the meeting the market pricing has risen to 70%.

The five key signals: The Monetary Policy Committee (MPC) minutes from the February meeting, along with the updated economic forecasts, offered five clear signals that the BoE is firmly on a path of policy tightening and has become more hawkish since November:

1) While noting downside risks from Brexit to investment and household income growth, the BoE upgraded its economic forecasts compared to November (Table 1, 2 and 3). This came despite the new assumption of tighter financial conditions coming from a higher expected path for the policy rate and stronger trade-weighted sterling. The BoE noted the firming domestic wage growth and improving global backdrop.
2) The BoE's new growth forecast averages c1.75% over the forecast horizon; well above the BoE's estimate of potential supply growth (c1.5%). According to the minutes, because of the excess demand growth over supply growth, with the economy at, or above, full employment, 'domestic inflationary pressures are expected to rise' while the temporary hit from higher import prices since the Brexit vote fades.
3) The BoE expects the headline inflation rate to remain above its 2% target through to 2021. As a result, the minutes note explicitly, 'the outlook for growth and inflation was likely to require some ongoing withdrawal of monetary stimulus'.
4) The BoE is becoming less concerned about Brexit risks to near-term demand relative to the risks of the ongoing overshoot of inflation relative to the 2% target, 'the prospect of a greater degree of excess demand over the forecast period and the expectation that inflation would remain above the target have further diminished the trade-off that the MPC is required to balance.'
5) The minutes stated clearly that the committee had become more hawkish since the November report, 'the Committee judges that, were the economy to evolve broadly in line with the February Inflation Report projections, monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November Report'.

POLICY OUTLOOK
At the time of the November Inflation Report, markets had priced in a second hike in H2 2018 with around two such hikes over the next three years. Meanwhile, we had expected the BoE to hike again in May already, with three such hikes over the next two years. Today's communication from the BoE, which gives a nod to the new market pricing of three hikes in three years, is now broadly in line with our view and the new market pricing. We thus see a high probability that the BoE hikes by 25bps in May, followed by another 25bps hike in November, with at least one further hike in 2019.

ECONOMIC IMPACT OF TIGHTER MONETARY POLICY
Even with a modest continued tightening in which the Bank Rate increased to 1.25% by the end of 2019, UK monetary policy would remain highly accommodative. In our base case, which seems consistent with the BoE's guidance for "gradual" and "limited" rate hikes, the real policy rate would remain negative and the bank's balance sheet large by historical standards. We also note that the costs of business and consumer credit and mortgages are set by market forces, not directly by the BoE. The rise in borrowing costs in the real economy is, therefore, likely to be less than any eventual increases in the Bank Rate. The risks to the

outlook for a gradual monetary tightening depend on the outlook for wage growth. Continued tight labour market conditions point to rising nominal wage growth toward 3% by late 2018 from current rates of around 2.5%. We expect the BoE to tighten by more (or less) than our base case if wage growth surprises to the upside (or downside).

MONETARY POLICY SUMMARY
The MPC voted:

- For the bank rate to be maintained at 0.5%;
- For the BoE to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion;
- For the BoE to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435bn.

On the Bank Rate, stock of purchased assets, the Committee voted unanimously in favour of all three propositions.

Table 1: GDP	**2017**	**2018**	**2019**	**2020**
Bank of England Feb. 2018	1.9	1.8	1.8	1.8
Bank of England Nov. 2017	1.6	1.6	1.7	1.7
Berenberg estimates	1.8	1.8	1.9	

Table 2: CPI inflation	**2018 Q1**	**2019 Q1**	**2020 Q1**	**2021 Q1**
Bank of England Feb. 2018	2.9	2.3	2.2	2.1
Bank of England Nov. 2017	2.6	2.3	2.2	
Berenberg estimates	2.9	2.4		

Source: BoE, table 5.B, page 34, February Inflation Report 2018 Berenberg.

Table 3: LFS unemployment rate	**2018 Q1**	**2019 Q1**	**2020 Q1**	**2021 Q1**
Bank of England Feb. 2018	4.3	4.2	4.1	4.1
Bank of England Nov. 2017	4.2	4.2	4.2	
Berenberg estimates	4.3	4.3		

Source: BoE, table 5.B, page 34, February Inflation Report 2018 Berenberg.

Table 4: Bank rate	**2018 Q1**	**2019 Q1**	**2020 Q1**	**2021 Q1**
Bank of England Feb. 2018	0.5	0.8	1.0	1.2
Bank of England Nov. 2017	0.5	0.8	0.9	
Berenberg estimates	0.5	1.0		

Source: BoE, table 5.A, page 34, February Inflation Report 2018 Berenberg.

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