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BOE LOOKS PAST WEAK Q1, OPTS FOR A HAWKISH HOLD

Berenberg Macro Flash

BOE - ACTING AS A BUFFER AMID TEMPORARY WEAKNESSES

Central banks can play an important role in times of uncertainty. By keeping rates on hold at the May Inflation Report, having previously prepared markets for a hike before stepping them down again, the Bank of England (BoE) is serving as the buffer to the modest drop in market confidence about the UK economic outlook. This drop in sentiment follows the softer-than-expected pace of GDP growth in Q1 and rising global trade and geopolitical risks. Brexit uncertainties add to the BoE's cautiousness. Despite the delay to the next rate hike, the Monetary Policy Committee (MPC) minutes from the May meeting, along with the updated economic forecasts, suggest that the MPC's long-term policy outlook for a gradual tightening of monetary policy remains unchanged.

In the Q&A after the policy statement, BoE Governor Mark Carney said that the core message from the BoE is that the public should expect a 'gradual and limited tightening' in the years to come. We therefore continue to look for the next rate hike in November following a modest rebound in economic activity heading into the middle of 2018.

KEY TAKEAWAYS FROM THE MAY INFLATION REPORT

- **Medium-term growth outlook broadly unchanged:** The minutes from the May meeting show that the BoE is looking through the Q1 weakness. In the press conference Carney noted that one-off factors mean that the initial estimate of 0.1% qoq growth probably overstates the extend to which economic activity softened at the start of the year. The MPC's 'central view was that Q1 growth would be revised up over time to around 0.3%'. While the Q1 drop has lead to a downward revision to the BoE's 2018 forecast, from 1.8% to 1.4%, the 2019 and 2020 projections remain broadly unchanged at c1.7% per year, just 0.1pt below the February forecast.
- **The MPC is still focused on inflation risks despite downgrades to the near-term outlook:** The MPC has reduced its near-term inflation forecast for 2018 to 2.4% from 2.7% as the impact of the weaker sterling on import prices since the Brexit vote is fading faster than expected. However, further out, the profile for inflation is just 0.1pt lower as the committee judges that 'wage growth and domestic cost pressures are firming gradually, broadly as expected'. The minutes note the MPC sees building inflation risks over time due to continued above-trend demand growth. In its central forecast, the committee notes that 'GDP is expected to grow by around 1% per year on average over the forecast period', and 'while modest by historical standards, the projected pace of GDP growth over the forecast is nonetheless slightly faster than the diminished rate of supply growth, which averages around 1% per year.'
- **The hawks were unmoved:** Two members of the nine member MPC thought that a hike was needed now, as the 'weakness in the Q1 GDP data to be temporary or erratic' and as a result, a rate hike could 'mitigate the risks of a more sustained period of above-target inflation that might ultimately necessitate a more abrupt subsequent change in policy.' The two members that voted for a hike, Ian McCafferty and Michael Saunders, are both known hawks and had voted for a rate hike already at the previous MPC meeting in March.
- **Key forward guidance:** As MPC decisions work on a majority vote, what matters for the policy outlook is when, and if, some of the remaining seven members vote for a hike. When summarising the views of these members, the minutes noted that, because of the Q1 softness, the BoE should hold for now because, 'the costs to waiting for additional information were likely to be modest, given the need for only limited tightening over the forecast period to return inflation sustainably to the target'. But critically, when summarising the collective judgement of the MPC the minutes noted that 'the Committee's best collective judgement therefore remains that, were the economy to develop broadly in line with the May Inflation Report projections, an on-going tightening of monetary poli-

cy over the forecast period would be appropriate to return inflation sustainably to its target.' This key piece of guidance is broadly unchanged from recent meetings.

- **Keep an eye on the underlying assumptions:** The BoE conditions its forecast on the market-implied rate outlook at the time of the forecast. Although the MPC now expects inflation to return to 2% by 2020, this is conditioned on the market-implied path, which projects three 25 bps hikes over the next three years – broadly unchanged since February. As a result, we might deduce that on the current economic outlook, the MPC consensus view is probably in line with this market implied path at the time of the May forecast.

POLICY OUTLOOK – A DATA DRIVEN GRADUAL TIGHTENING

Markets currently price in around a c65% chance of a rate hike before the end of 2018 – with the distribution split between the August and November Inflation Reports. Although we expect growth to rebound in Q2, we think the BoE will need to see evidence that the stronger growth is sustained in Q3 before hiking again – this puts us in the November camp for the next hike. If data really surprise to the upside in the coming months and wage growth accelerates to well above 3% yoy (currently 2.8%), then August could come into play for the next hike. Further out, the market implied path for three hikes in three years is slightly below our own outlook for one hike in late 2018 and two hikes in 2019. This outlook depends on a rebound in demand growth in mid-2018 and a pick-up in wages. 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 growth in GDP and wages surprises to the upside (or downside).

Even with a modest continued tightening in which the Bank Rate increased to 1.25% by the end of 2019 (our base case). UK monetary policy would remain highly accommodative in such an outlook and consistent with the BoE's guidance for "gradual" and "limited" rate hikes, in our view. The real policy rate would remain negative and the bank's balance sheet large by historical standards.

MONETARY POLICY SUMMARY

The MPC voted for:

- The Bank Rate be maintained at 0.5%;
- 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;

Regarding the Bank Rate, seven members of the Committee (the Governor, Ben Broadbent, Jon Cunliffe, Dave Ramsden, 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.

Table 1: GDP	**2018**	**2019**	**2020**
Bank of England May 2018	1.4	1.7	1.7
Bank of England Feb. 2018	1.8	1.8	1.8
Berenberg estimates	1.5	1.8	

Table 2: CPI inflation	**2018 Q2**	**2019 Q2**	**2020 Q2**	**2021 Q2**
Bank of England May 2018	2.4	2.1	2.0	2.0
Bank of England Feb. 2018	2.7	2.2	2.1	
Berenberg estimates	2.6	2.3		

Source: BoE, table 5.B, page 30, May Inflation Report 2018 Berenberg.

Table 3: LFS unemployment rate	2018 Q2	2019 Q2	2020 Q2	2021 Q2
Bank of England May 2018	4.1	4.0	4.0	4.0
Bank of England Feb. 2018	4.2	4.2	4.1	
Berenberg estimates	4.2	4.2		

Source: BoE, table 5.B, page 30, May Inflation Report 2018 Berenberg.

Table 4: Bank rate	2018 Q2	2019 Q2	2020 Q2	2021 Q2
Bank of England May 2018	0.6	0.9	1.1	1.2
Bank of England Feb. 2018	0.5	0.9	1.1	
Berenberg estimates	0.5	1.0		

Source: BoE, table 5.A, page 30, May Inflation Report 2018 Berenberg.

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