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Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

BOE TO MARKETS – STEP UP RATE HIKE EXPECTATIONS

Berenberg Macro Flash

TWO IS THE MAGIC NUMBER, NOT THREE

The BoE expects to raise interest rates slightly faster than the markets have priced in so far. This was the BoE's key message today. The market implied path at the time of the BoE's August forecast had rates reaching 1% by Q3 2020. On this basis, the minutes from today's August Monetary Policy Committee meeting stated that '*conditioned on the gently rising path of Bank Rate implied by current market yields, CPI inflation remains slightly above 2% through most of the forecast period, reaching the target in the third year.*' And that, '*an on-going tightening of monetary policy over the forecast period would be appropriate to return inflation sustainably to the 2% target at a conventional horizon.*' In his press conference commentary BoE Governor Mark Carney stated clearly that the BoE views two years as the '*conventional horizon*'.

Although the BoE delivered a modestly hawkish message today, the bank's guidance and press conference comments by Governor Carney did not give a signal on the precise timing for the next hike. This fits with our house view for the path of interest rates. We expect the BoE to wait until after Brexit in March 2019 before hiking again. As long as the UK avoids a no-deal hard-Brexit (20% risk), we then look for the BoE to pick up the pace of rate hikes to two per year in 2019 and 2020 with the next hike coming in May 2019 – this would take the Bank Rate to 1.75% by Q4 2020 (1.5% by Q3 2020). This is roughly twice as many hikes as the market had priced in ahead for the BoE's policy decision.

OTHER TAKEAWAYS FROM THE AUGUST INFLATION REPORT

- **Medium-term growth outlook broadly unchanged:** The UK's growth rate in real GDP rebounded – probably to around 0.4% qoq - in Q2 from 0.2% qoq in Q1. Data for Q3 remain robust and forward looking indicators suggest some upside risk to growth later this year. The August minutes note that '*GDP is expected to grow by around 1¾% per year on average over the forecast period…… slightly faster than the diminished rate of supply growth, which averages around 1½% per year.*' The BoE's profile for growth in 2018 (1.4%), 2019 (1.8%, up from 1.7%), and 2020 (1.7%) is in line with our own projections – Table 1.
- **Upward revision to CPI:** The BoE has slightly revised up its projected annual inflation outlook (as measured by CPI), mainly due to a higher-than-expected oil prices and a weaker sterling compared to May. The marginal upward revision due to external factors will not have affected the BoE's policy outlook which is set in relation to the outlook for domestic cost pressures. This outlook is broadly unchanged since May – Chart 2.
- **Three conditions for future rate hikes:** We think the BoE will continue to gradually raise the Bank Rate so long as three conditions are met: 1) the economy continues to expand at a rate above the BoE's 1.5% estimate of potential growth; 2) wage growth continues to gradual edge up in response to tightening labour markets (currently 2.7% yoy); and 3) the UK avoids a no-deal hard-Brexit.
- **Mind the Brexit risk:** The August minutes only mention Brexit once – when discussing the current evidence that uncertainty linked to Brexit is weighing on business uncertainty. Although the minutes do not refer to any BoE contingency plans for a hard-Brexit, Governor Carney said that, if any Brexit outcome was '*disinflationary*', the BoE would adjust its policy '*if and when'* necessary. In our view, if the hard Brexit risk materialised, the initial response from the BoE would be similar to its response after Brexit vote – an injection of stimulus followed by a period of closely watching the data to see how policy should respond thereafter.
- **Bank Rate is still well below BoE's estimate of the equilibrium rate:** Following the Fed, the BoE has added an estimate of the equilibrium interest rate to its arsenal of key projections it uses to provide guidance on its expected policy path. Analysis in the August Inflation Report defines the equilibrium rate as 'the interest rate that, if the economy starts from a position with no output gap

and inflation at the target, would sustain output at potential and inflation at the target.' The BoE estimates that the range for the equilibrium Bank Rate is 2-3% - this is in line with our expectation of 2.5%. Even after hiking today, the BoE's main policy rate is good 1.75ppt below the equilibrium rate. By definition, as long as the economy remains at close to full capacity, monetary policy would only be tight if and when the Bank Rate exceeds the BoE's estimate of the equilibrium rate. Based on our forecast for the path of rate hikes, which we think is broadly in line with the BoE's latest policy guidance, monetary policy is set to remain highly accommodate well into the medium-term.

MONETARY POLICY SUMMARY

The Committee voted unanimously in favour of all of the three following propositions:

- The Bank Rate should be increased by 0.25 percentage points, to 0.75%;
- 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.

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

Table 2: CPI inflation	**2018 Q3**	**2019 Q3**	**2020 Q3**	**2021 Q3**
Bank of England August 2018	2.5	2.2	2.1	2.0
Bank of England May 2018	2.4	2.1	2.0	
Berenberg estimates	2.4	2.2	2.2	

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

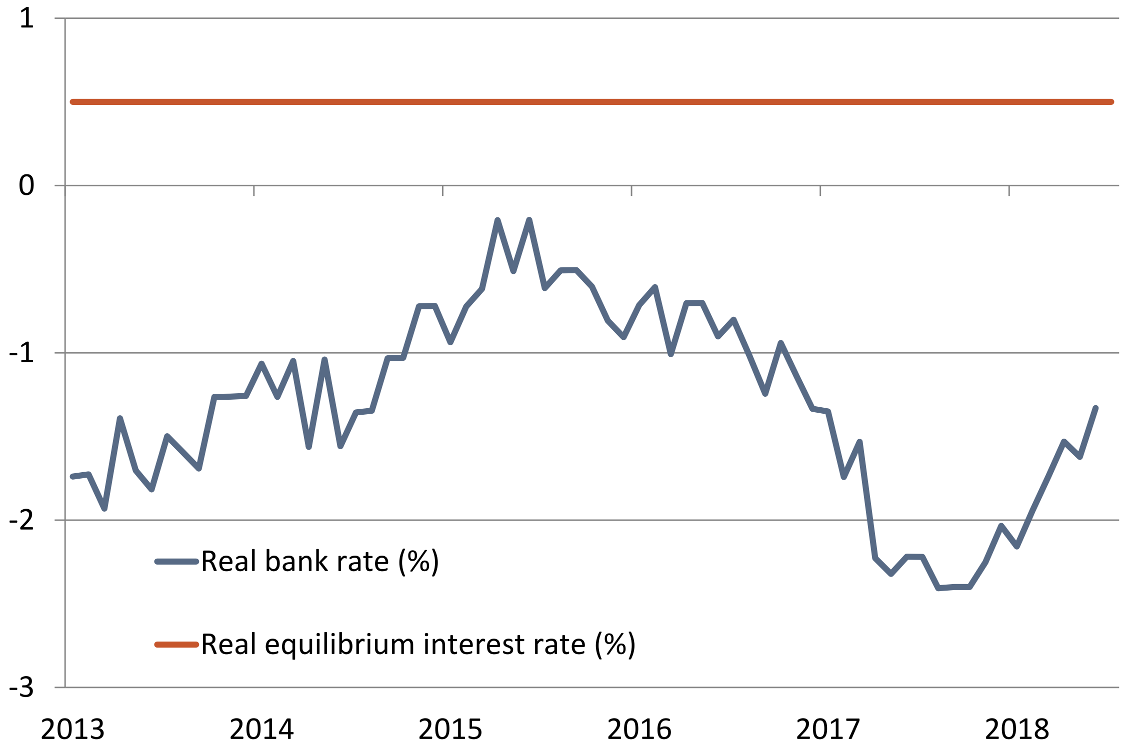
Table 3: LFS unemployment rate	**2018 Q3**	**2019 Q3**	**2020 Q3**	**2021 Q3**
Bank of England August 2018	4.0	3.9	3.9	3.9
Bank of England May 2018	4.1	4.0	4.0	
Berenberg estimates	4.2	4.0	3.9	

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

Table 4: Bank Rate	**2018 Q3**	**2019 Q3**	**2020 Q3**	**2021 Q3**
Bank of England August 2018	0.6	0.9	1.0	1.1
Bank of England May 2018	0.7	1.0	1.2	
Berenberg estimates	0.75	1.00	1.5	

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

Chart 1: Real Bank Rate versus real equilibrium interest rate (%)



Monthly data. Source: ONS, Bank of England. Real rates adjusted for the consumer price index excluding energy, food, alcoholic beverages and tobacco. We have taken 2.5% as the nominal equilibrium rate based on the 2-3% estimated range and subtracted the BoE's 2% inflation target from it.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com