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BOE PREVIEW - BALANCING INFLATION AND BREXIT RISKS

Berenberg Macro Flash

THE BANK OF ENGLAND'S DILEMMA

Brexit comes first: On the one hand, economic data supports the case for a continued normalisation of monetary policy. On the other hand, the noisy Brexit negotiations and heightened uncertainty about the potential outcome warrants a cautious 'wait-and-see' approach to setting rates. Fortunately, the BoE, through its past actions, has created for itself some breathing space. By raising rates twice already during the past year, and by signalling more hikes in the coming years, the BoE has done enough to keep inflation expectations sufficiently well anchored to insure against a serious upside inflation surprise before Brexit is settled, even as domestic supply and demand conditions tighten – Chart 1.

No surprises this week: Our base case is that the next hike (25bps) will come in May 2019. However, if Brexit is settled soon (not impossible) and wage data continues to improve strongly in the coming months, the next hike could come as soon as February. But as the BoE would have plenty opportunity to prepare markets for a hike early next year once Brexit is settled, we do not expect the bank to turn more hawkish at the upcoming November Inflation Report on Thursday already.

FOCUS ON THE FUNDAMENTALS

The limited data available for the fourth quarter suggests the UK economy has lost a little of its third quarter momentum, with improvements in production offset by a moderation in consumer spending growth after the World Cup-related summer splurge. Following real GDP growth of around 0.6% qoq in Q3 (Berenberg estimate) we expect the quarterly growth rate to slow to roughly trend of 0.4% in Q4 (risks are tilted a little to the upside).

Recent labour market data support the BoE's judgement that the UK is operating at close to, or a little above, full employment (current unemployment is 4.0%). Although employment growth has stalled in recent months, labour demand remains strong. The number of job vacancies rose to a record high in September, while regular wage growth in August picked up to 3.1% yoy - the fastest rate since 2009.

Survey data for producers remains mixed with global uncertainties, including trade-wars and the recent sell-off in markets, piling on top of pre-existing domestic worries linked to Brexit. Business investment growth has been subdued so far this year. Firms are reluctant to commit to major long-lived investment projects until they have a clearer sight on Brexit. Because of high rates of capacity utilisation and healthy gains in demand, firms' reluctance to add to productive capacity raises medium-term inflation risks.

Amid the weakness in supply growth, domestic spending and the outlook for the UK consumer will remain central to the BoE's policy deliberations in this and upcoming policy meetings. Consumer confidence is gradually edging up, albeit in a jerky fashion, as real wage growth improves. Household appetites for major purchases are at a post-Lehman high. Forward looking inflation expectations based on consumer surveys have held at close to 3% for well over a year - above the 2% rate consistent with the BoE's target.

Expect the BoE to highlight the improving outlook for demand growth based on accelerating wage growth, amid subdued supply growth, as the key justification for signalling that a continued policy normalisation is likely over the medium-term.

In the August Inflation Report the BoE forecast that real GDP growth would average 1.75% over the forecast horizon. While such growth is low on a historical basis, the BoE noted that it is still 'slightly faster than the diminished rate of supply growth (1.5% per year)' – Chart 2. Following on from the package of fiscal policy measures announced on Monday by Chancellor Phillip Hammond, we would not be surprised if the BoE added 0.1 to its medium-term growth forecasts, or suggested that the latest fiscal adjustment - especially planned income tax cuts in 2019 - adds some upside risk to demand growth and thus the inflation outlook.

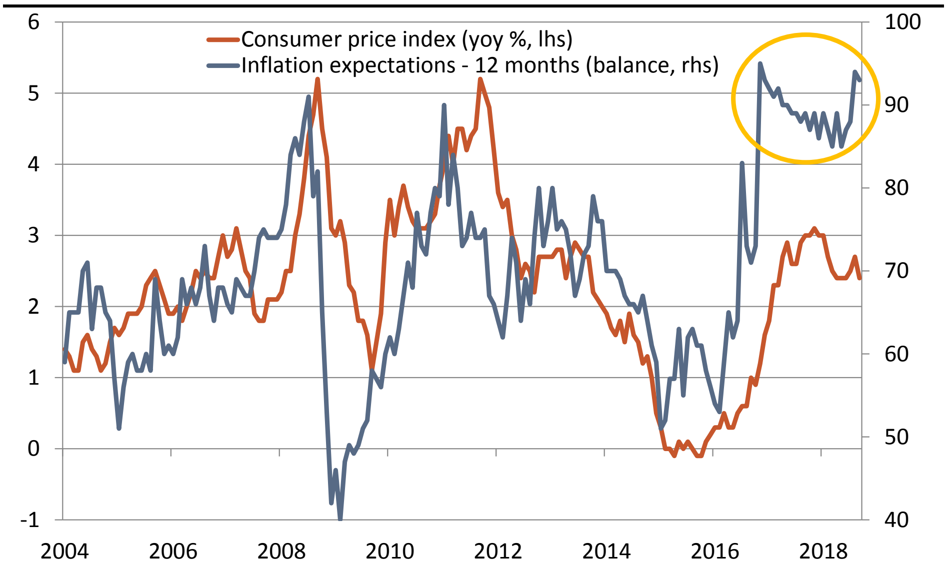
Markets would, and should, take any upgrade to the economic outlook as a hawkish signal. Following the recent increase in the oil price, the BoE may raise its near-term inflation forecast – Chart 3. However, as the higher oil price is an external rather than domestic driver of inflation, higher inflation due to this factor alone should not be taken as a hawkish signal. At this meeting, it may make sense to pay more attention to the GDP forecasts than inflation.

MEDIUM-TERM POLICY OUTLOOK
The market continues to underestimate the pace of the forthcoming tightening, in our view. Whereas we expect two hikes per year in 2019 and 2020, the market currently prices in no more than one hike per year.

For the BoE's immediate policy decision, near-term Brexit risks are likely to matter more than its expected medium-term outlook for growth and inflation. The BoE knows that a continued normalisation of monetary policy hinges on a sensible Brexit agreement that avoids the damaging no-deal hard-Brexit scenario. We put this risk at 20%. Reuters report that the average across market economists is 25%. This may partly explain our more hawkish outlook for monetary policy.

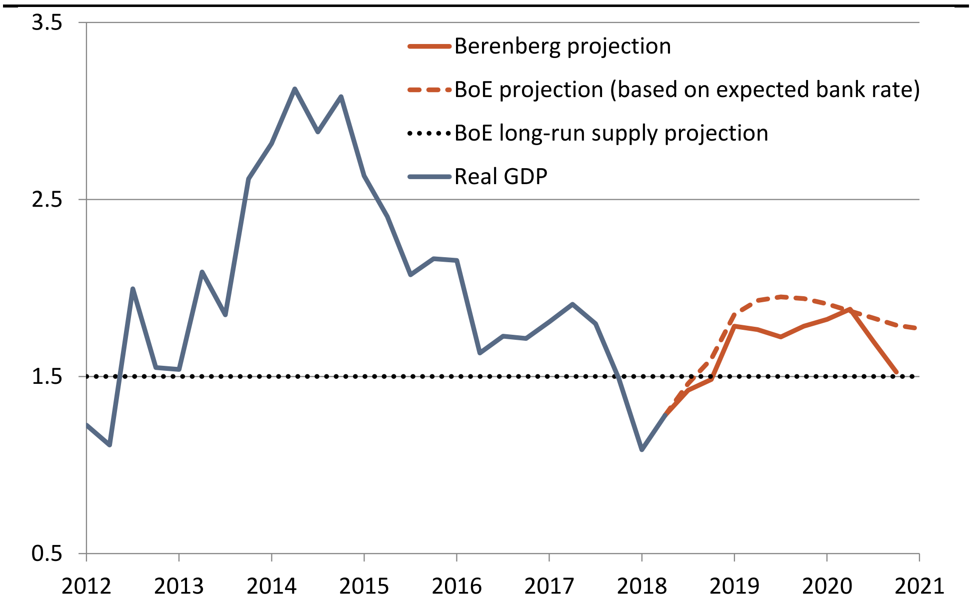
Turning to the immediate policy decision on Thursday: on the back of rising cost pressures from weak supply growth and improving consumer fundamentals, the BoE will maintain its guidance that the nine member policy committee expects to gradually lift rates in the coming years. But for now, expect the BoE to unanimously a) keep rates on hold; and b) make no changes to the bank's balance sheet.

Chart 1: Headline inflation versus inflation expectations



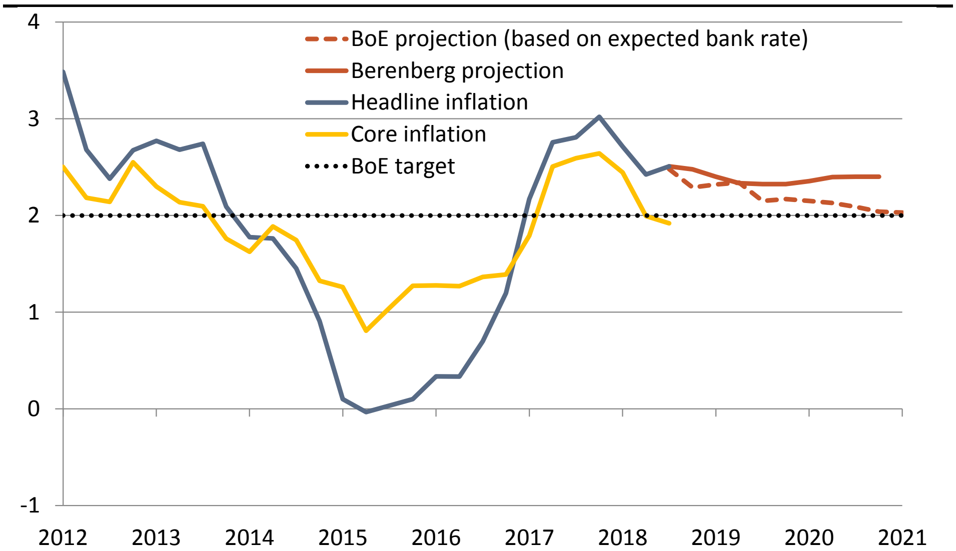
Monthly data. Source: ONS, GfK

Chart 2: GDP and BoE projections (yoy %)



Quarterly data. Source: Bank of England, ONS, Berenberg calculations. Forecasts show BoE mean projections from August 2018 Inflation Report. Supply projection based on guidance from policy summary of August 2017 Inflation Report. The 'expected bank rate' is calculated by the BoE on the average of market pricing ahead of the forecast round.

Chart 3: Headline inflation and BoE projections (yoy %)



Quarterly data. Source: Bank of England, ONS, Berenberg calculations. Core inflation = headline CPI minus food and energy. Forecasts show BoE mean projections from August 2018 Inflation Report. The 'expected bank rate' is calculated by the BoE on the average of market pricing ahead of the forecast round.

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