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BOE PREVIEW: HAWKISH BUT NOT HIKING, YET

Berenberg Macro Flash

The Bank of England (BoE) is in a bind

Before raising rates again the BoE would probably prefer to wait until Brexit is resolved to avoid adding to the current climate of uncertainty. It might not have that luxury, however. Even though the Brexit-vote related inflation bulge has faded the UK looks ready for modestly higher rates still. Since the Brexit vote in June 2016, the BoE has raised rates twice – Chart 1. But labour markets continue to tighten and wage growth is accelerating. Inflation expectations have risen on a sustained basis. Evidence that households are growing increasingly uncertain about the path of rates adds to inflation risks by weakening the BoE's perceived reaction function. On Thursday BoE Governor Mark Carney may hint at another hike as soon as August, even if Brexit remains unresolved heading into H2 2019.

Building medium-term inflation risks

Three trends suggest that inflation is likely to rise over time:

1) *Elevated inflation expectations – Chart 2.* Inflation expectations have remained elevated since the c15% drop in trade-weighted sterling after the Brexit vote in June 2016 temporarily pushed headline inflation towards 3%. Even though headline consumer price inflation has fallen below the BoE's 2% yoy target recently - March headline and core inflation came in at 1.9% - the five year break-even rate which capture markets' inflation expectations has risen above 3% again in recent months while household inflation expectations have hit a post-Lehman high.
2) *Building excess demand – Chart 3.* Demand growth has remained resilient since the Brexit vote. By Q4 2018 real consumption was c5% higher than in Q2 2016. But the uncertainty about the future trading relationship between the UK and its biggest market the EU has weakened business sentiment. Real private business investment has stagnated over the same period. The BoE estimates that the UK is now operating at full capacity. Demand growth that continues to exceed supply capacity will push up the general price level over time.
3) *Rising wage costs – Chart 4.* UK labour markets are tight. At 3.9% in February the unemployment rate was at its lowest since 1975 and below the BoE's estimate of full employment. Labour demand remains solid. Job vacancies are at a near-record high. Weekly wages have ticked up towards 3.5% yoy in recent months while unit labour costs – which adjust for changes in productivity – have risen above 3% after falling on an annual basis as recently as 2015.

Recent developments and likely forecast changes

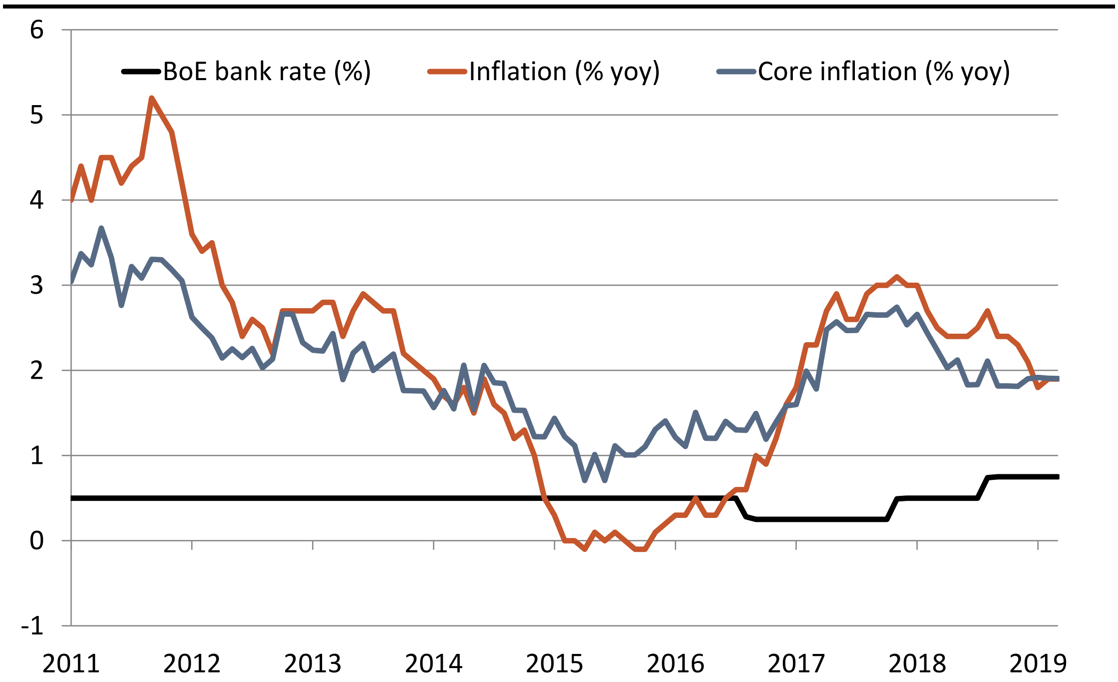
UK economic momentum has remained subdued but stable since the most recent Inflation Report in February. Real GDP probably expanded by 0.2% qoq in the first quarter of 2019, the same rate as Q4 2018. Household spending remains a bright spot along with the labour market, while confidence and businesses' risk appetites remain soft. On Thursday the BoE may nudge its projection for unemployment down 0.1-0.2ppt over the forecast horizon while keeping the inflation and GDP outlook mostly unchanged.

In its communication the BoE will likely focus on the fact that, due to the unexpected uncertainty linked to the latest six month Brexit delay, the risks to the economic outlook are higher than usual, both to the upside and to the downside. The end state – hard Brexit, semi-soft or soft Brexit, or no Brexit – and how long it takes to reach will have a major bearing on developments in the UK economy and the path of the BoE policy rate.

Policy outlook and guidance – looking for an even clearer signal
At the most recent regular monetary policy meeting in March the BoE's nine member Monetary Policy Committee (MPC) voted unanimously in favour of keeping rates on hold while continuing to signal that 'an on-going tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate'. We expect the MPC to repeat this voting pattern and to reiterate such guidance on Thursday. However, Governor Carney may look to strengthen the signal by hinting that a hike could come as soon as the next Inflation Report in August.

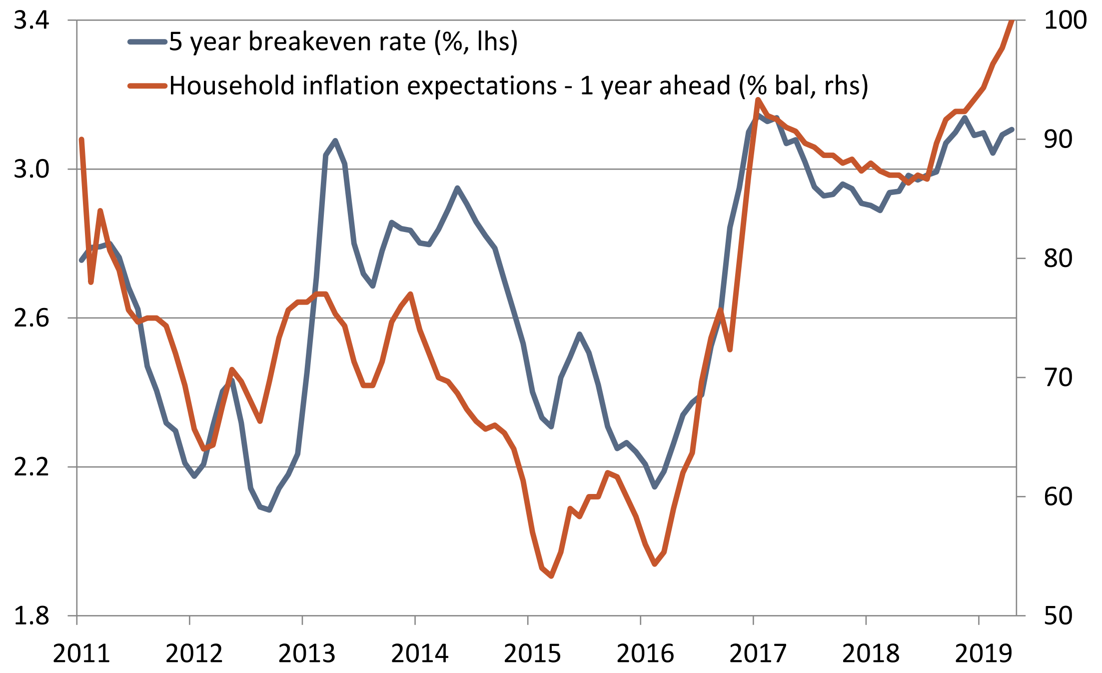
A strong signal would be needed to ready markets if indeed a hike is coming soon. Market expectations have become more dovish in recent months. According to Bloomberg, markets see just a c25% probability of a hike in 2019, compared to c47% in February. While this may be in part due to the unexpected additional Brexit delay it highlights a bigger problem for the bank. The BoE's own surveys show a record proportion of households have no idea where interest rates are heading next – Chart 5. So much for forward guidance!

Chart 1: Core and headline inflation versus BoE bank rate



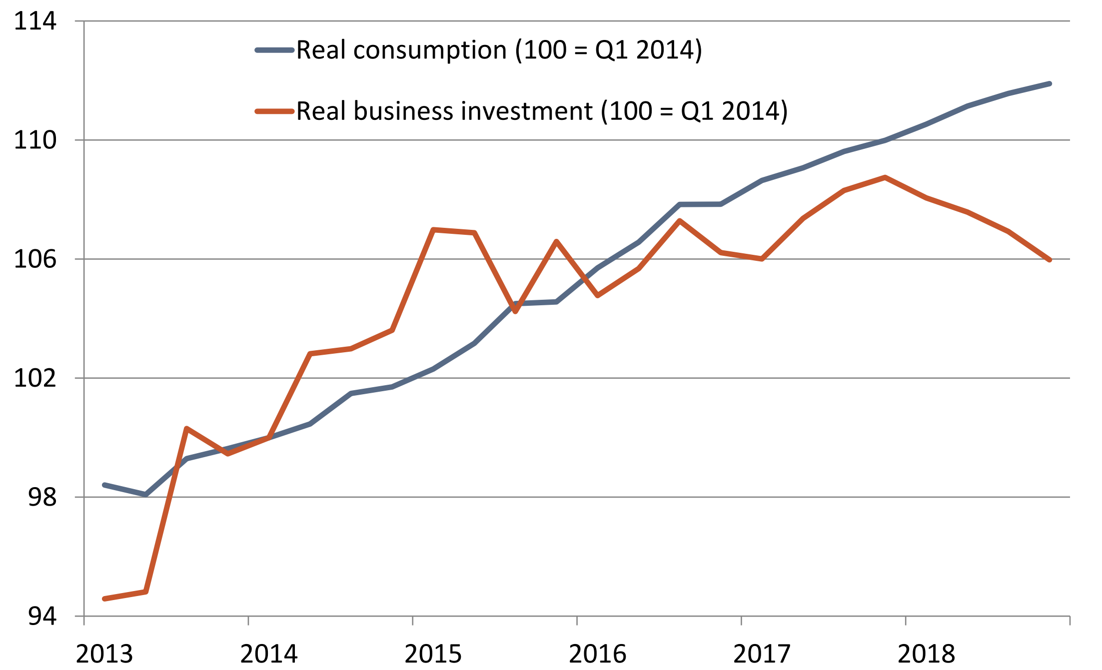
Monthly data. Source: BoE, ONS. Inflation = consumer price index.

Chart 2: Inflation expectations have risen sharply on a sustained basis



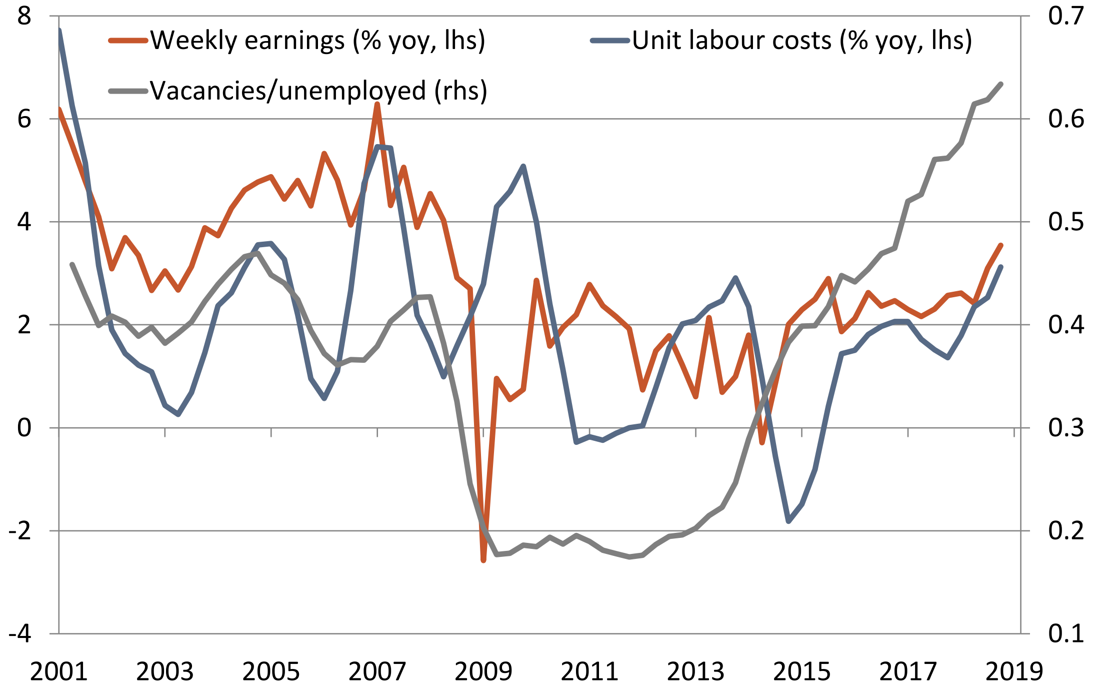
Monthly data. Source: Bloomberg, GfK. Data show three month moving average. Household expectations show proportion of survey that expect inflation to rise over the next 12 months.

Chart 3: Growth composition: gains in demand while investment stalls



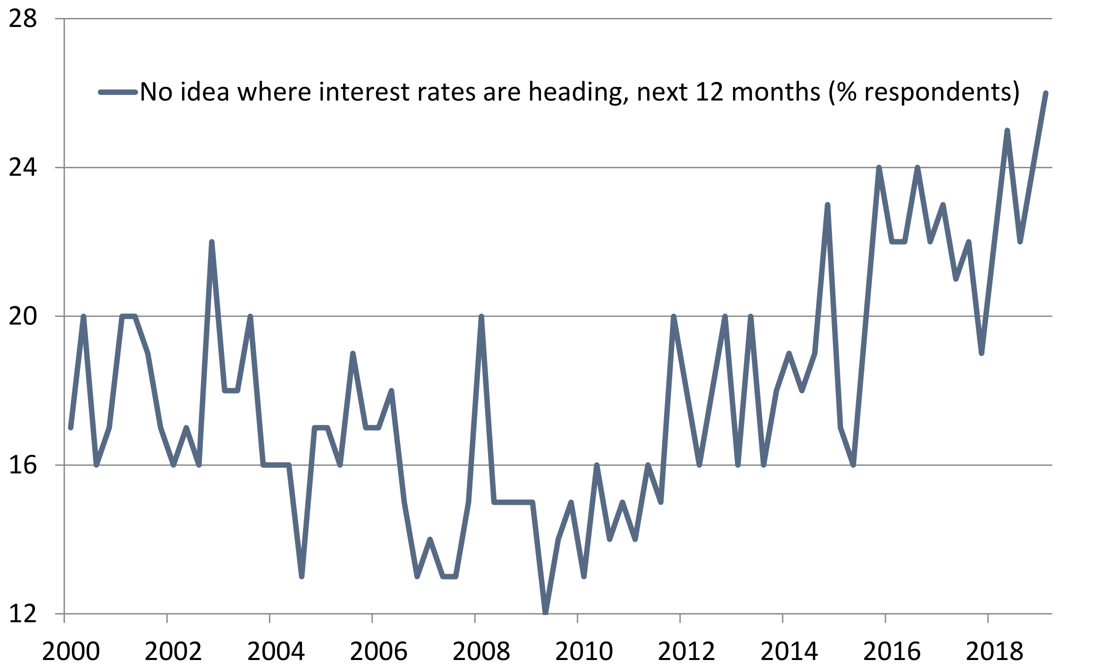
Quarterly data. Source: ONS. Investment data show three month moving average.

Chart 4: Tight labour markets are driving wage costs higher



Quarterly data. Source: ONS, Berenberg calculations

Chart 5: Households are becoming less clear about where rates are heading



Quarterly data. Source: BoE, TNS.

Table 1: GDP	2019	2020	2021
Bank of England Feb. 2019	1.2	1.5	1.9
Berenberg	1.2	2.1	

Table 2: CPI inflation	2019	2020	2021
Bank of England Feb. 2019	2.0	2.1	2.1
Berenberg	2.0	2.2	

Table 3: LFS unemployment rate	2019	2020	2021
Bank of England Feb. 2019	4.1	4.1	3.9
Berenberg	3.8	3.7	

Source: Bank of England, Berenberg.

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