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BOE STRENGTHENS GUIDANCE - AUGUST HIKE POSSIBLE

Berenberg Macro Flash

August rate hike still on the table: Although the BoE kept its key polices on hold today it continued to signal a policy normalisation over the medium-term '*The market curve is unequal to meeting the task of the BoE's remit*'. Seldom do central banks say so clearly – in their own somewhat contorted words - that the market has got it wrong, in their view. At the time the BoE collected the data for its May forecast round the market was pricing in just one rate hike by the end of 2021. The BoE signaled it expects a steeper normalisation path than this. As monetary policy operates with a lag, and as the BoE expects inflation to rise above its 2% target by the end of 2021, the signaled normalisation is likely to be front-loaded. If the UK government sorts the Brexit mess out soon – thus dodging the hard Brexit risk – or is clearly on such a path, a rate hike as soon as August remains on the cards.

We thus continue to expect the next rate 25bps rate hike in August followed by two further such hikes in 2020. The current bank rate is 0.75%.

In the press conference following the statement, BoE governor Mark Carney focused on rising inflation risks in the labour market and '*considerable*' excess demand by the end of the updated forecast. The minutes from the May meeting note that *'Excess demand rises above 1% of potential output by the end of the forecast period'.* Carney noted that, due to Brexit uncertainties, firms have opted to raise productive capacity via hiring rather than investment since June 2016 amid elevated uncertainty about Brexit. Consequently, the outperformance in labour demand has pushed up wage costs above rates that are consistent with the BoE meeting its 2% inflation target in the medium-term.

Forecast changes

The BoE's forecast offers additional clues to the path of rates. The snippet from the May minutes that summaries the updated forecasts and the MPC's conclusions has a hawkish bias: the updated projections *'embodied a significant margin of excess demand and a path for CPI inflation that was above target, and still rising, in the latter part of the forecast period'.*

The policy statement adds '*The labour market remains tight…and unit labour cost growth has strengthened to rates that are above historical averages*'. While the BoE noted some near-term impacts from Brexit, linked to uncertainty impacting business activity and volatility in stockpiling, the BoE assumes a smooth transition to a new UK-EU trading relationship (i.e. no hard Brexit).

The key forecast changes are as follows:

-Real GDP (Table 1): The BoE raised its forecast over the next three years. In line with our recent upgrade the BoE lifted its 2019 forecast to 1.5% from 1.2%, following stronger than expected momentum in the first quarter. The BoE now sees growth accelerating to 2.1% by 2021 – from 1.9% previously, driven by faster growth in real consumption on the back of continued healthy expected gains in real income growth and stronger business investment as Brexit uncertainties fade. This is well above the BoE's estimate of potential growth of c1.5%.

-Unemployment rate (Table 2): Amid strong labour demand and continued stronger-than-expected employment growth the BoE lowered its unemployment forecast over the next three years. It now expects unemployment to fall to a rate of 3.6% by 2021 from 3.9% previously.

-Inflation (Table 3): Due to downgrades to the BoE projections of retail energy prices, the inflation outlook is lower in the first half of the updated forecast but unchanged towards the end. The BoE now forecasts consumer price inflation of 1.6% yoy in 2019 from 2.0% previously, 2.0% in 2020 from 2.1% previously, but unchanged at 2.1% in 2021.

Policy guidance and outlook

In the May minutes the MPC maintained its February guidance that '*The Committee continued to judge that, were the economy to develop broadly in line with its Inflation Report projections, an ongoing tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate to return inflation sustainably to the 2% target at a conventional horizon'.*

In addition, the minutes provide an additional comment on the precise path of rates: '*In the MPC's central projection, conditioned on a path for Bank Rate that rose to around 1% by the end of the forecast period, domestic inflationary pressures were expected to firm as excess demand built, such that CPI inflation picked up to above the 2% target and was still rising at the end of the three-year forecast period'.* In our view, this guidance is consistent with at least one rate hike per year between 2019 and 2021. We therefore continue to expect one hike in August 2019 and two hikes in 2020. The market prices in only a 23% chance of a hike in 2019.

May monetary policy decision

The MPC voted unanimously to maintain:

- the Bank Rate at 0.75%;

- the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion;

- the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

Table 1: GDP, % yoy	2019	2020	2021
Bank of England May 2019	1.5	1.6	2.1
Bank of England Feb. 2019	1.2	1.5	1.9
Berenberg	1.5	2.1	

Table 2: CPI inflation, % yoy	2019	2020	2021
Bank of England May 2019	1.6	2.0	2.1
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 May 2019	3.8	3.8	3.6
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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