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

BOE PREVIEW: BREXIT CONTINGENT GUIDANCE

Berenberg Macro Flash

GUIDANCE FOR TWO SCENARIOS

The BoE's August Inflation Report on Thursday should not be missed. It will mark the last 'super Thursday' - when the BoE publishes new forecasts, releases Monetary Policy Committee (MPC) meeting minutes, updates its forward guidance and holds a press conference - before Brexit is scheduled to happen on October 31. While MPC will meet again in September, and policymakers will get a chance to communicate to markets via ad hoc speeches ahead of Brexit, the BoE is likely to set out its stall for the various possible Brexit outcomes this week.

We expect the BoE to offer two sets of guidance: As its base case, the BoE will signal continued rate hikes over the medium-term, on the assumption that there is an orderly Brexit on October 31 – or even in another lengthy delay. But more than before, we expect the BoE to emphasise how it may act in the downside scenario of a hard Brexit at the end of October. With pro-Brexit Boris Johnson becoming UK Prime Minister, this has become a much more pertinent issue in recent weeks. Expect the BoE to signal that 'more likely than not' it would ease policy to help buffer the shock of a no deal Brexit outcome.

MODEST DOWNGRADES TO NEAR-TERM OUTLOOK

UK economic data has mostly surprised to the downside since the BoE last updated its economic forecasts in May - especially production and spending. The weakness is due to the intensification of Brexit-related uncertainties and the protracted softness in global trade and production linked to the slowdown in China and the noisy US-China trade negotiations. While continuing to assume a 'smooth' Brexit, the BoE will probably downgrade its 2019 real GDP forecast from 1.5% in May to close to our forecast of 1.3%. However, we see two reasons why the outlook further out will mostly remain unchanged (May real GDP forecast = 1.6% yoy in 2020 and 2.1% in 2021) even though the global outlook has become bleaker since May.

1) The BoE's conditioning assumption for the path of the bank rate – which is based on forward market rates – has declined by around 35bps versus May. As Chart 1 shows, the May forecasts had been conditioned on the assumption of a gradually rising bank rate, by c15bps one year by mid-2020. The August forecasts are likely to be conditioned on c20bps cut over the next year. On its own, the assumption of looser monetary policy will lift the BoE's projections for domestic demand growth and for exports an implied weaker sterling.

2) The BoE will likely factor in stronger government spending growth that may add 0.1-0.2pt to forecasts for real GDP growth over the forecast horizon. Boris Johnson plans to step up government departmental spending and spending on preparations for a no-deal Brexit. He promises further stimulus via tax cuts and infrastructure spending.

The BoE may add 0.1-0.2ppt to its 2019 projections for CPI inflation, mostly due to the recent drop in sterling which will push up import costs. The BoE may highlight upside risks to inflation further out stemming from the proposed pro-cyclical fiscal stimulus. As recent labour market data points to continued, albeit slowing, employment growth the BoE may keep its forecast that unemployment will decline to 3.6% by 2021 unchanged.

POLICY PREDICTIONS FOR THE AUGUST MPC MEETING

We expect the nine-member policy setting committee to vote unanimously in favour of keeping all elements of BoE policy – rates and balance sheet – unchanged on Thursday. The critical information will be contained in the guidance that relates to potential Brexit outcomes.

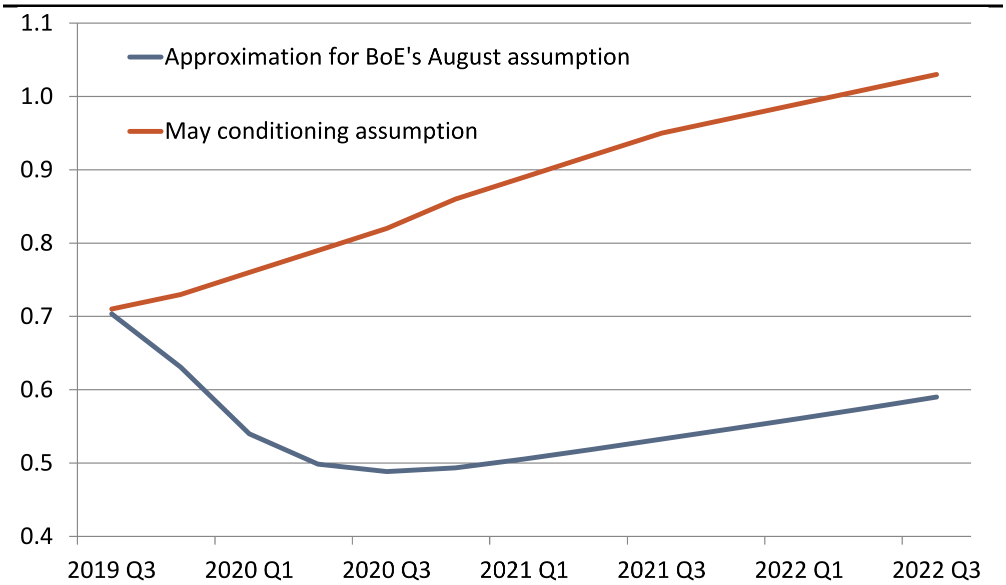
In case of an orderly Brexit, we expect the BoE to reiterate its message that '*The Committee continued to judge that, were the economy to develop broadly in line with its May Inflation Report projections that included an assumption of a smooth Brexit, an ongoing tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate*'.

In case of a hard Brexit, we expect the BoE to rehash Carney's comment at the 26 June 2019 Treasury Select Committee, '*it's more likely [than not] that we would provide some stimulus in that event [of a no-deal Brexit]*'.

POLICY OUTLOOK

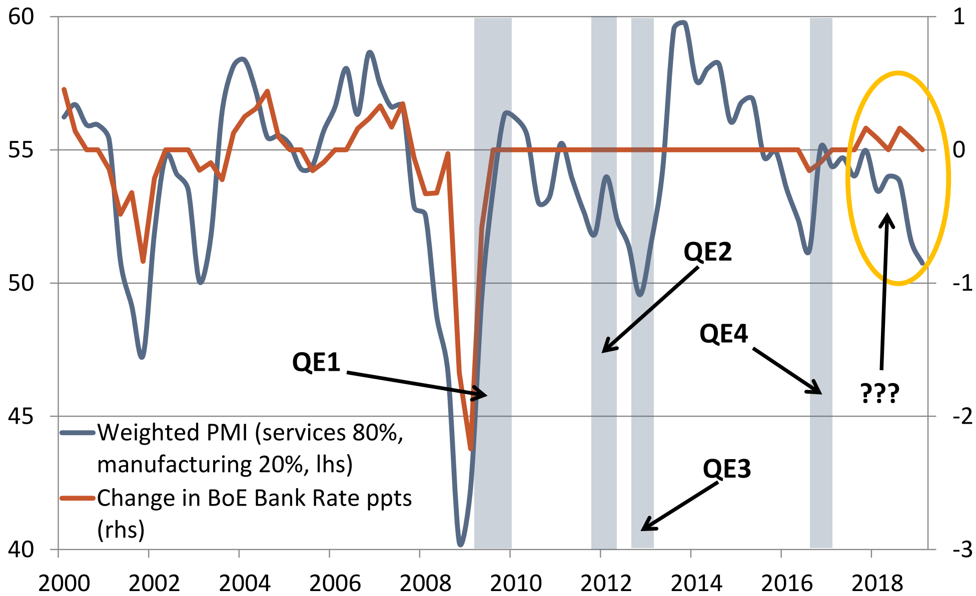
If history is any guide, the BoE would already be easing by now given the recent dip in UK economic data – Chart 2. But the BoE is concerned about growing inflation risks stemming from a tightening labour market, which is pushing up wage growth and unit labour costs. As the BoE places most of the blame for the recent economic weakness on Brexit, it expects it to be only a temporary problem that will reverse once (if) Brexit is resolved. As our base case, we look for the BoE to keep the bank rate unchanged at 0.75% in 2H 2019 before hiking rates twice in 2020 and once in 2021, by 0.25bp each time. That would take the bank rate to 1.5% by end-2020. Of course, if things go badly wrong – that is, if the UK ends up with a hard Brexit (40% risk) or the global economy enters a genuine downturn – the BoE would change its tune fast.

Chart 1: BoE Bank Rate assumption May versus August estimate (%)



Quarterly. Bank Rate projections are based on forward market interest rates. The August approximation is based on the ten day average of the OIS forward curve to 25 July 2019.

Chart 2: Quarterly weighted PMI versus change in bank rate and QE



Source: Markit/CIPS, BoE, Berenberg calculations. QE shading highlights purchases of Gilts only. QE1: £200bn from March 2009 to January 2010. QE2: £125bn from October 2011 to May 2012. QE3: £50bn from July 2012 to November 2012. QE4: £70bn from August 2016 to April 2017. QE4: £60bn from August 2016 to February 2017.

Table 1: GDP (% yoy)	2019	2020	2021
Bank of England May 2019	1.5	1.6	2.1
Berenberg	1.3	1.9	1.7
Table 2: CPI inflation (% yoy)	**2019**	**2020**	**2021**
Bank of England May 2019	2.0	2.1	2.1
Berenberg	1.6	2.0	2.1
Table 3: LFS unemployment rate (%)	**2019**	**2020**	**2021**
Bank of England May 2019	3.8	3.6	3.5
Berenberg	3.8	3.6	3.6

Source: Bank of England, Berenberg.

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