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BOE, AT ODDS WITH FED AND ECB, STAYS HAWKISH

Berenberg Macro Flash

We will not be moved: The BoE remained on hold this month – at odds with the US Fed that cut its benchmark interest rate by 25bps yesterday, the second such cut since August, and the ECB that last week cut rates and restarted bond purchases. In the minutes for the September MPC (Monetary Policy Committee) meeting, the forward guidance remained largely unchanged from previous months, 'assuming a smooth Brexit and some recovery in global growth … the Committee judged that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate to return inflation sustainably to the 2% target'.

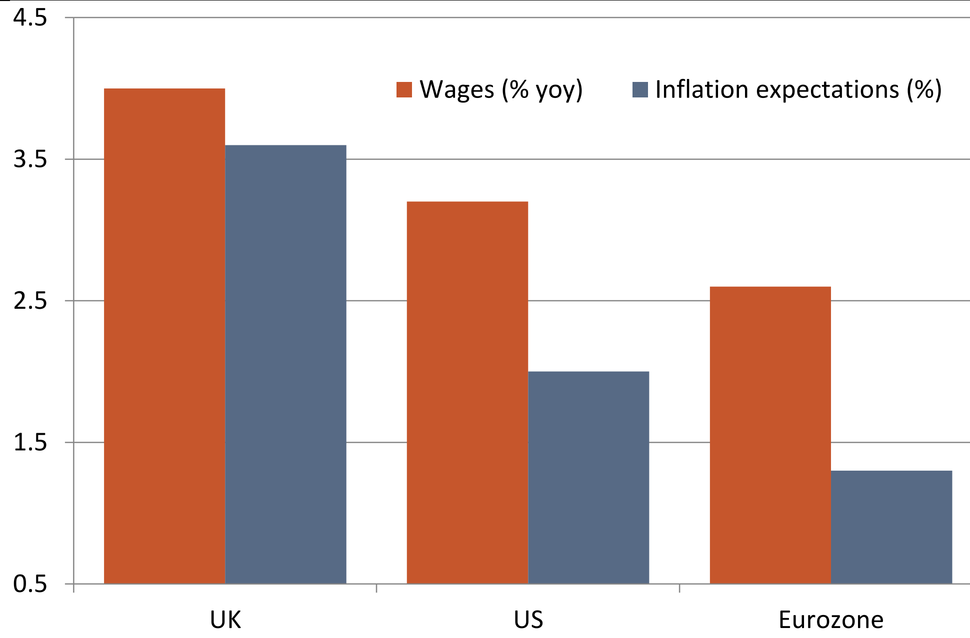
The two new pieces of information relevant for updating market expectations are as follows:
1. The MPC judges that a further Brexit delay would weaken near-term inflationary pressures, 'The longer … uncertainties persist … the more likely it is that demand growth will remain below potential …. In such an eventuality, domestically generated inflationary pressures would be reduced.'
2. The BoE has factored in the recent fiscal policy plans into its policy decisions, 'the Government has announced a significant increase in departmental spending for 2020-21, which could raise GDP by around 0.4% over the MPC's forecast period, all else equal.' This will, at the margin, add upside risks to the medium-term inflation outlook.

Overall, the BoE fundamentally remains hawkish on a medium-term view, but by noting that a further Brexit delay would likely be disinflationary, it has signalled that it will probably not hike Brexit resolved in case of a further delay..

The BoE's dilemma: Worried about Brexit risks, the BoE has moved too slowly with its policy normalisation over the past two years, hiking rates just twice to take the bank rate from 0.25% to 0.75%. But the initial temporary inflation shock following the Brexit vote has had persisting effects on inflation expectations which continue to trend upwards. Current market-implied indicators suggest inflation expectations are 3.6% (5-year-5-year inflation swaps) - well above the BoE's 2% inflation target. Meanwhile, wage growth is accelerating as the labour market tightens. At 4.0% yoy, wage growth in July hit a post-Lehman high. This is a far cry from the US and especially the Eurozone where wage growth and inflation expectations are much more muted – Chart 1. The BoE's hawkishness is thus consistent with the data that, on balance, points to growing inflation risks on the horizon.

Policy outlook: The outlook and timing of any monetary policy move mostly depends on Brexit developments. In case of a hard Brexit the BoE would likely cut rates and restart its asset purchases (35% probability). That is not our base case however. In case of an orderly (35% chance) or no Brexit (30%) we expect, in line with the BoE's guidance, a series of gradual rate hikes starting shortly after an orderly Brexit or a reversal of Brexit has occurred. We look for the next hike to come in Q3 2020 with risks tilted towards a hike before then if wage growth continues to surprise to the upside and orderly Brexit happens sooner than expected.

Chart 1: Wage growth and inflation expectations for the UK, the US and the Eurozone



Inflation expectations data based on 5 year/5 year inflation swap taken on 19/09/19. UK wage data based on July average weekly earnings. US wage data based on August average hourly earnings. Eurozone data based on Q2 wages and salaries data. Source: ONS, Bureau of Labour Statistics, Eurostat.

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