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UK REBOUND: NO NEED FOR A HELPING HAND FROM THE BOE

Berenberg Macro Flash

Dovish signal from the BoE: In a speech today, BoE governor Mark Carney hinted at a potential near-term stimulus: "there is a debate at the MPC over the relative merits of near-term stimulus to reinforce the expected recovery in UK growth and inflation". The governor of the BoE does not make such comments lightly. Our base case is for the BoE to remain on hold in H1 2020 as economic momentum rebounds. We then expect the BoE to hike the bank rate by 25bp in Q3 2020. Carney's comments today highlight the risks to this call. We thus cannot rule out a surprise rate cut or the restarting of asset purchases in the very near term. While Carney also noted that the BoE forecasts these "negative trends to reverse", we believe it would be unnecessary for the BoE to seek to "reinforce the expected recovery".

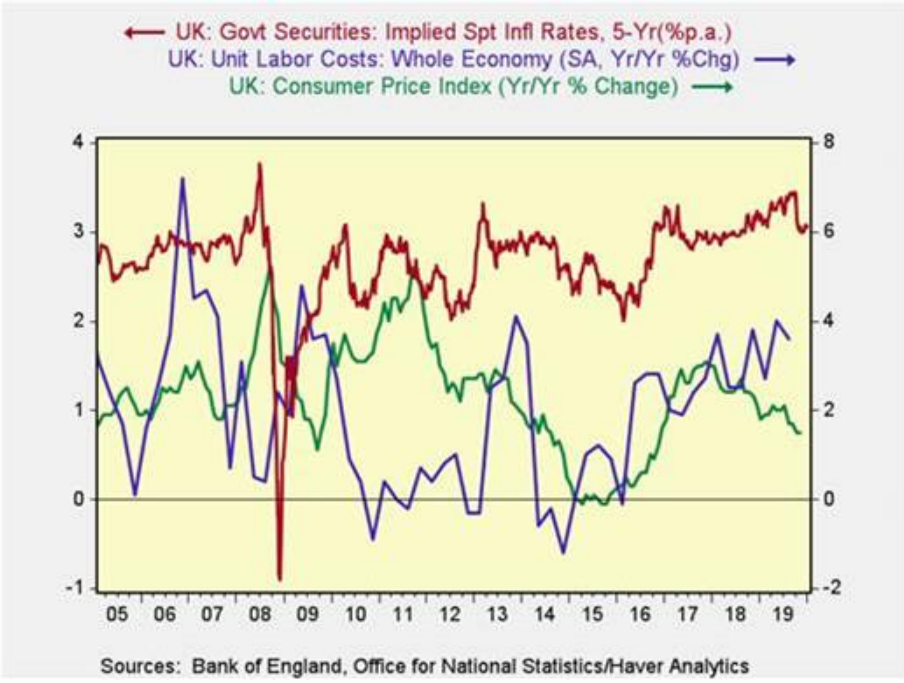
Improving economic outlook

Although the risk of a semi-hard Brexit at the end of 2020 will continue to hang over the UK, the sweeping 12 December election win for Johnson and his Conservative Party has brought much of the damaging uncertainty of recent years to an end. Amid the clearer outlook, we see three positive factors that can underpin an economic rebound, with real GDP growth up from 1.3% in 2019 to 1.8% in 2020E and 2.1% in 2021E.

1. A recovery in global demand should lift output in export-oriented industries. Latest survey data for production expectations among manufacturers of intermediate and investment goods have bottomed out, with some tentative signs that a rebound is already underway.
2. Less domestic political uncertainty can lift household confidence and underpin a pickup in real consumption growth. Wages are rising at a decent clip, while households' finances remain solid. Facing fewer risks, consumers should now have the confidence to spend more.
3. Government spending growth is accelerating. At the September 2019 Spending Round, Chancellor Sajid Javid already set out plans for the fastest growth in day-to-day government spending in 15 years. Expect a further step-up in public sector investment spending at the upcoming budget (11 March).

Economic data suggests that monetary conditions are easy anyway

Although inflation has edged down a little in recent months – due to external factors such as the sterling appreciation and the drop in energy prices – unit labour cost growth and inflation expectations remain close to their post-Lehman highs (Chart 1). In addition, growth in broad money and credit to businesses is accelerating while lending growth to individuals remains firm (Chart 2).



What's the use? The risk from cutting rates or embarking on asset purchases now is that the BoE may be forced to sharply reverse course if inflation risks emerge later this year. Separately, amid the already easy monetary conditions, and with benchmark rates low across the curve (current 10-year gilt yield at 0.8%), a 25bp cut to the base rate – currently 0.75% – or a short burst of QE would have little economic benefit.

Policy outlook

The latest Monetary Policy Committee minutes from December 2019 note that:

"Monetary policy could respond in either direction to changes in the economic outlook in order to ensure a sustainable return of inflation to the 2% target... If global growth fails to stabilise or if Brexit uncertainties remain entrenched, monetary policy may need to reinforce the expected recovery in UK GDP growth and inflation. Further ahead, provided these risks do not materialise and the economy recovers broadly in line with the MPC's latest projections, some modest tightening of policy, at a gradual pace and to a limited extent, may be needed to maintain inflation sustainably at the target."

Reacting to still-elevated risks in the near term, we expect the BoE to remain somewhat dovish in the coming months. We then expect it to tone down its dovishness quickly once it sees clear evidence that the economy is improving on its own. This would set the stage for a 25bp hike in Q3 2020 followed by another 25bp hike in Q3 2021. This would take the bank rate to a still-low 1.25% by the end of 2021.

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