BERENBERG
PARTNERSHIP SINCE 1590

MACRO NEWS 01/08/16

Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 20 3465 2672

BOE PREVIEW: GOING FOR A GOLDILOCKS STIMULUS

Berenberg Macro Flash

Soft data for the month of July indicate that the UK economy has slowed abruptly following the Brexit vote, with a risk of recession in the second half of 2016. In light of the comments made in the past month by the BoE governor Mark Carney 'easing over the summer', plus explicit guidance in the July meeting minutes that 'most members of the Committee expect monetary policy to be loosened in August', it is not a question of if the BoE will ease policy later this week, but by how much.

At the August Inflation Report on Thursday, the Bank of England's nine member Monetary Policy Committee will meet for the second time since the UK voted to leave the EU on June 23. Alongside its standard release of the minutes and policy changes from the meeting, governor Carney will present a set of revised forecasts and policy statement, followed by a Q&A.

Goldilocks policy

If the BoE does too little, say, just a rate cut, that would be insufficient to have any meaningful positive effect on demand and risks causing a knee-jerk re-pricing in financial markets. If the BoE does too much, it could spook households and markets into thinking the economy is in worse shape than it is. Coming out too hot could be worse than coming out too cold. The BoE's challenge is to send a well balanced signal of a firm intent to do 'whatever it takes' without exacerbating the existing blow to confidence coming from the Brexit-vote.

We expect a rate cut (25 bps), see 60% chance of more QE (£50-100bn), and importantly, look for a strong verbal signal that the BoE is ready to do more if necessary using its full range of policy levers.

Forget about the July meeting

The MPC's decision to hold steady in July despite market expectations that the BoE would cut the bank rate should not raise questions about the bank's ability or willingness to act. Monetary policy works with a lag. Acting sooner, rather than later, has obvious advantages. But waiting three more weeks hasn't made much difference. After falling to record lows in late June, sterling and gilt yields have mostly moved sideways since the July MPC meeting. By waiting, the BoE has not run the risk of being perceived as acting in haste or panic which could have reinforced bearish behaviours in markets and in the real economy. Further, by publishing forecasts alongside policy changes, it makes clear the bank's reaction function for any potential future policy changes if conditions deteriorate further.

Forecasts revisions – growth and employment down, inflation up

Despite the better-than-expected performance of GDP in the second quarter (0.6% qoq versus expectations 0.4%), the BoE will downgrade its medium-term forecasts for GDP and employment. The Brexit-vote has led to a rise in uncertainty and a fall in confidence. Household spending growth is likely to slow in the near-term while business investment will contract. On the upside, in contrast to past episodes of weak sterling, early evidence indicates that the 15% drop in trade-weighted sterling since last November is providing a modest boost to UK exports.

With just a few breadcrumbs of soft data for the post-vote period, it is not yet clear if UK GDP growth will slow, stagnate or turn negative in the near-term. Risks are heavily tilted to the downside. The BoE, along with other central banks, uses its forecasts as a form of forward guidance. If the BoE forecasts zero growth but no recession, alongside a rate cut and a modest QE package, that would hint that the BoE would probably step up its easing should the economy actually begin to contract.

Our best guess is that the BoE will remain broadly upbeat about the UK's good fundamentals, referring to the strong labour market, improved private sector balance sheets and more resilient financial system compared to 2008/09 or 2011/12. But the BoE will point to potential risks coming from fragility in the housing market, a fall in demand for credit and heightened risk that firms begin to reduce headcounts as a precautionary measure.

From its November 2015 peak to June 22, trade-weighted sterling fell by almost 7%. Sterling has declined by a further 9.5% since the Brexit-vote. In the near-term, the weaker sterling will cause import prices to rise, outweighing the disinflationary effects of weaker demand. As such, the BoE will revise its near-term inflation forecasts up, possibly above the 2% target by the turn of the year. The jump in inflation will not however, play a big role in the MPC's policy deliberations. The committee, as in 2008/09, will look through the temporarily higher inflation and focus instead on targeting a recovery in domestic demand.

What could the BoE do?

With the current policy rate at 0.5% and given past references to negative interest rates by the BoE governor Mark Carney as 'a zero sum game' – we doubt the BoE will go much beyond a 25bp rate cut. In past easing cycles, the BoE has, on average, reduced the policy rate by 3ppts. Instead, we look for the BoE to restart its QE programme (60% probability) and increase its existing £375bn stock of assets in order to stimulate demand. How big will the response be? As a start, we expect the BoE to buy between £50bn-100bn of assets, increasing if necessary until economic conditions improve. Other potential policy changes could include adding corporate debt to the purchases to support the prices of risky assets. Or, in conjunction with the Treasury, the BoE could bulk up the Funding for Lending scheme, designed to reduce bank and building societies funding costs so long as they increase lending.

At this stage, in the absence of hard data, we expect the BoE to go opt for a simple clear message to signal the BoE is doing what it can to limit the downside risks. This could boost confidence and ensure that the day-to-day spending activities of households and businesses are not disrupted.

The bottom line is this: interest rate cuts and QE are not panaceas for political uncertainty. The crucial factor weighing on the UK growth outlook is the uncertainty relating to the Brexit negotiations and new trade deal with the EU. Until negotiations with the EU begin in earnest, uncertainty will act like a brake on the UK economic engine.

Please see our latest Chart of the Week for analysis on recent BoE easing cycles.

This message has been produced for information purposes for institutional investors or market professionals, it is not a financial analysis within the meaning of § 34b or § 31 of the German Securities Trading Act (Wertpapierhandelsgesetz), no investment advice or recommendation to buy financial instruments. The message does not claim completeness regarding the information on the developments referred to in it. On no account should it be regarded as a substitute for the recipient's procuring information for himself or exercising his own judgements. The message may include certain descriptions, statements, estimates, and conclusions underlining potential development based on assumptions, which may turn out to be incorrect. Berenberg and/or its employees accept no liability whatsoever for any direct or consequential loss or damages of any kind arising out of the use of this message or any part of its content. -- For full economics reports please visit our website or contact capitalmarkets@berenberg.de.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
Kallum.pickering@berenberg.com