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BOE INFLATION REPORT PREVIEW – AN OPPORTUNITY TO TAKE STOCK

Berenberg Macro Flash

Better safe than sorry: Who knows what might have happened if the Bank of England (BoE) had not eased monetary policy so aggressively some three months ago at the August Inflation Report. But it's probably safe to say, given that the economy has weathered the near-term confidence shock well and markets have largely taken the Brexit-vote in their stride, that the BoE's actions have probably done some good. The Brexit vote was a major market event at the time and it remains a serious economic risk to the UK.

The BoE's decision to provide extra liquidity around the vote and then to announce a suitably large monetary stimulus in response to the sharp downgrades in the market's assessment of the UK's economic outlook was appropriate. A central bank needs to satisfy the markets' need for liquidity during periods of stress to limit the risk that a modest crisis turns into a severe one. But the UK's better-than-expected economic performance since the vote has removed the need for the BoE to act again.

We expect the BoE to use tomorrow's November Inflation Report as an opportunity to take stock on the state of the economy and the effectiveness of its policies, while sending a strong signal that the BoE stands ready to do more if economic conditions were to deteriorate. We will be looking closely at the BoE's assessment of the forthcoming inflationary headwinds to consumption, the impact of hard-Brexit fears on investment, and, if any, the policy implications of the recent weakening of sterling.

Economic performance since the August Inflation Report

Despite the roller-coaster performance of the soft data - dropping sharply in July before rebounding again in August and September - the underlying economy has expanded at a stable rate around trend since the Brexit vote. GDP expanded by 0.5% qoq in Q3, according to the first estimate, driven by domestic-orientated services. The second estimate - published in a few weeks - will give a detailed assessment of changes in both demand (consumption) and supply (investment). The Q3 GDP performance was well above the BoE's August forecast (0.1% qoq) and its updated near-cast referenced in the minutes of the September Monetary Policy Committee Meeting (0.3% qoq and 0.4% in the revised estimate). It's a little too early to say for certain how the economy is holding up in Q4, but early indicators point to a continued stable expansion in output. We forecast growth of 0.4% qoq.

Other key economic data has also been a little better-than-expected since August. Labour market conditions have remained healthy, sentiment in the housing market has improved after a mid-year dip and private sector credit conditions have remained at pre-referendum levels. Inflation has increased broadly in line with expectations. But it remains well below the 2% target. So far, the rise in inflation to 1% in September - after 0.6% in August - was mostly driven by the washing out of previous disinflationary forces, rather than the weaker sterling.

Impact of the August stimulus package

At its August MPC meeting, the BoE's rate-setting committee agreed on a broad package of measures aimed at offsetting the negative shock coming from the Brexit vote. In addition to a 25bp rate cut, £10bn in corporate bond purchases and a new Term Funding Scheme, the BoE announced that it would purchase £60bn of gilts over six months, taking the total stock of QE assets to £435bn by January 2017.

The effectiveness of the policy measures will be hard to judge. First there is a timing issue. Monetary policy works with a lag so it's a bit early to tell how August's measures have affected economic activity. And second, since the economy is starting from a relatively strong point - private sector credit conditions and domestic demand were in good shape to begin with - the measure of success will be by how little conditions deteriorate from this point on.

We can already see some changes taking place in the normal policy channels.

Real interest rate and cash-flow channel: The Term Funding Scheme aims to reinforce the pass-through of rate cuts to credit markets. Early signs suggest it has been a success. Interest rates on short-term business loans and standard variable rate mortgages have fallen by roughly the size of the cut in the policy rate (25bp). Lower funding costs and savings rates should reduce debt financing costs and encourage economic agents to bring forward spending. By value, four-fifths of non-financials loans are floating rates and half of mortgages are, the effects of the rate cut should positively hit demand in the coming months.

Credit channel: The lower policy rate should reduce funding costs for banks and lenders, thus raising the supply of credit to the real economy. Consumer credit growth heading into the referendum was strong at a decade-high. It has remained at this record high level since the vote.

Wealth channel: Lower interest rates plus the effects of portfolio rebalancing as the BoE buys assets should support financial market valuations. The prices of risky assets like equities have recovered strongly after an immediate post-vote dip. The BoE's QE programme probably helped asset prices recover following the immediate shock. Afterwards, the BoE asset purchases have reinforced the global environment of easy monetary policy that, supports asset prices more generally.

Exchange rate channel: Trade-weighted sterling has depreciated by 21.4% since November 2015. The major declines in the exchange rate occurred immediately after the vote and then between mid-September to mid-October. Market expectations that the BoE would ease monetary policy may have exacerbated the declines in sterling that occurred after the Brexit vote; however, the key factor underpinning the sterling weakness is the economic risk associated with Brexit. With the most recent leg down for sterling, the key driver was markets pricing in a higher risk of a hard Brexit. Coincidently, markets simultaneously reduced their chance of a second rate cut in 2016, suggesting monetary policy was not the major driving factor of the most recent sterling weakness.

Confidence and expectations channel: Confidence, along with growth expectations for the near and medium term have improved significantly following the immediate sharp deterioration after the Brexit vote. The policy measures taken by the BoE may have supported the general improvement in the outlook which has come about as the economy has withstood the initial Brexit shock better than expected.

Likely revisions to economic outlook

- We would expect modest upward revision to GDP growth in 2016 and 2017 following the resilient near-term performance of the economy. The BoE will likely highlight major risks such as the negative effects of the heightened risk of a hard-Brexit on confidence and the damage to real incomes from the sterling weakness.

- A possible downward revision to long-term potential growth if the BoE decided to reduce its assessment of the long-term supply potential of the economy following the heightened risk of a hard Brexit.
- An upward revision to medium-term inflation expectations is possible – the current level of trade-weighted sterling is 6% below the conditioning assumption of the August Inflation Report. In August, the BoE forecast sterling to remain stable on a trade-weighted basis to the end of 2018. The BoE will likely revise down its forecast for sterling following the recent fall.
- Unemployment will probably remain unchanged at this stage. The BoE has a poor record of forecasting unemployment. It will probably keep the medium-term outlook broadly unchanged while delaying the near-term rise as the labour market has held up a little better than expected.

Policy outlook

Here is the key piece of policy guidance that the BoE has incorporated into the MPC minutes since August.

"News on the near-term momentum of the UK economy had, however, been slightly to the upside relative to the August Inflation Report projections. The Committee would assess that news, along with other forthcoming indicators, during its November forecast round. If, in light of that full updated assessment, the outlook at that time was judged to be broadly consistent with the August Inflation Report projections, a majority of members expected to support a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year."

The resilient near-term performance, the upward revision for next year, and the bigger rise in medium-term inflation is probably enough to keep the BoE on hold tomorrow. However, if the economy was to weaken over the coming quarters, we would expect the BoE to ease monetary policy again and look through the temporarily higher inflation.

Despite recent comments from Governor Carney on the 'limits' to how much BoE officials can tolerate an overshoot of inflation above the 2% target, the probability of the BoE tightening policy in response to the falling sterling is very low. As long as the sterling selling is orderly, we see no major reason for the BoE to step in.

The weaker sterling is reducing household real incomes. Interest rate hikes on top of that would further damage the domestic economy. The BoE may reiterate risks around sterling but, ultimately, if demand began to seriously deteriorate, we would expect the MPC to vote in favour of more easing. This will likely be the key message tomorrow.

GDP	2016	2017	2018
August Inflation Report	2.0	0.8	1.8
Berenberg	2.0	1.5	1.5

Unemployment	2016 Q3	2017 Q3	2018 Q3	2019 Q3
August Inflation Report	5.0	5.4	5.6	5.3
Berenberg	5.0	5.3	5.3	

Inflation	2016 Q3	2017 Q3	2018 Q3	2019 Q3
August Inflation Report	0.8	1.9	2.4	2.4
Berenberg	0.7	2.6	2.0	

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