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## **BOE PREVIEW: IMPROVED RISK ASSESSMENT MAY PUSH YIELDS HIGHER**

### Berenberg Macro View

#### **ONE TO WATCH**

BoE policymakers meet this week against a backdrop of rapid vaccine progress at home and an improving global economic outlook. When the minutes are published at 12:00GMT on Thursday, financial markets will likely focus on the Monetary Policy Committee's assessment of the recent rise in gilt yields. Since the previous meeting on 4 February, 10 year gilt yields have jumped 40bps to 0.8% - their highest level since December 2019. While the increase in benchmark rates reflects higher inflation and stronger real growth expectations, the move is associated with sharp losses for gilt holders as well as higher discounted cashflows for tradeable companies – which may threaten some equity valuations. The rise in UK benchmark rates is part of a broader trend across the advanced world – Chart 1.

In the minutes from the February meeting, the BoE signalled that it would continue to support the economic recovery and lean against any downside risks to inflation. Policymakers emphasised that they did not intend to tighten policy until they were confident that inflation would return to the 2% target on a sustained basis. The minutes note:

*'Risk management considerations had implied that policy should lean strongly against downside risks to the outlook, to support the economy and to help to ensure that weakness in the economy was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target'*

*'If the outlook for inflation weakened, the Committee stood ready to take whatever additional action was necessary to achieve its remit. The Committee did not intend to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably'*

While the MPC is unlikely to adjust its policy in response to the latest rise in yields and will probably highlight the rise as a sign that economic prospects have improved, policymakers may signal that a faster pace of asset purchases remains an option in case yields rise to such an extent that tighter financial conditions could impair recovery momentum.

Such an intervention may offset some of the upward pressure on yields coming from a likely shift in the bank's improved risk assessment. On 8 March, governor Andrew Bailey noted that risks were turning *'increasingly two-sided'*. In a speech on 26 February, the BoE's chief economist and influential MPC member Andy Haldane said *'my judgement is that we might see a sharper and more sustained rise in UK inflation than expected'* – Chart 2.

Given the existing upward momentum in inflation and growth expectations, an absence of direct intervention to lean against rising rates combined with a more positive tone may add to upward



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pressure on yields. Markets should thus brace for some volatility following a potential further jump in benchmark rates.

**However, any near-term attempt by the BoE at fine-tuning long term rates, either via a strong verbal intervention or through a faster pace of asset purchases in the near-term, would only serve to temporarily suppress gilt yields. A sustained rise in bond yields is likely to be a trait of the early post-Covid upswing as inflation and productivity recovers across the advanced world. If that happens, equity and bond markets alike will need to adjust to the new higher yield environment.**

When judging the BoE's assessment of the rise in yields, markets should keep in mind three factors:

- 1) The ongoing rise in rates reflects a host of positive factors:** In the UK, these include, but are not limited to: 1) a rapid pace of vaccination which can allow a full and permanent re-opening by mid-June; 2) large excess household savings which could turbo-charge the consumer rebound – Chart 3; 3) an improving global backdrop, bolstered by a huge policy tailwind in the US and across Europe; and 4) a material reduction in Brexit uncertainty which has lifted business confidence. As long as rising benchmark rates are a sign of recovery and not a threat to it, the BoE probably will not see a need to intervene.
- 2) Benchmark rates are too low relative to the UK's sustainable long-run economic growth:** The 10 year gilt yield has risen by around 75bps from the historic low of 0.05% in August 2020. Relative to what the UK can probably manage in terms of sustainable nominal GDP annual growth (c3.7% to c4.3%), gilt yields are too low. If core inflation begins to trend above the BoE's 2% target from 2022 onwards, as we expect, benchmark rates will need to rise towards a more historical normal range of, say, 3% to 5%.
- 3) The BoE targets inflation, not interest rates:** At present, inflation expectations are edging higher and growth expectations are improving. Under such circumstances, policymakers are likely to view higher rates as a sign that policy is working. Policymakers also understand that financial markets are skittish. In contrast to current fears of an inflation overshoot, right up until the February MPC meeting, markets had bet that the BoE would cut rates below zero in 2021. While the BoE is not indifferent to market volatility, the level of interest rates or market valuations, they are all second order concerns and matter mostly insofar as such developments reinforce or undermine the BoE's pursuit of 2% annual consumer price inflation.

### POLICY OUTLOOK

Regarding its asset purchases, the BoE stated in the February MPC minutes that:

*'The existing programme of £150 billion of UK government bond purchases had started in January and the Committee continued to expect it to be completed by around the end of 2021. The Committee continued to envisage that the pace of purchases could remain at around its current level initially, with flexibility to slow the pace of purchases later'*

As our base case, we expect the BoE to continue its asset purchases at the current pace of £4.4bn per week during H1 2021 – Chart 4. That would leave c£41bn remaining of the £875bn gilts target.



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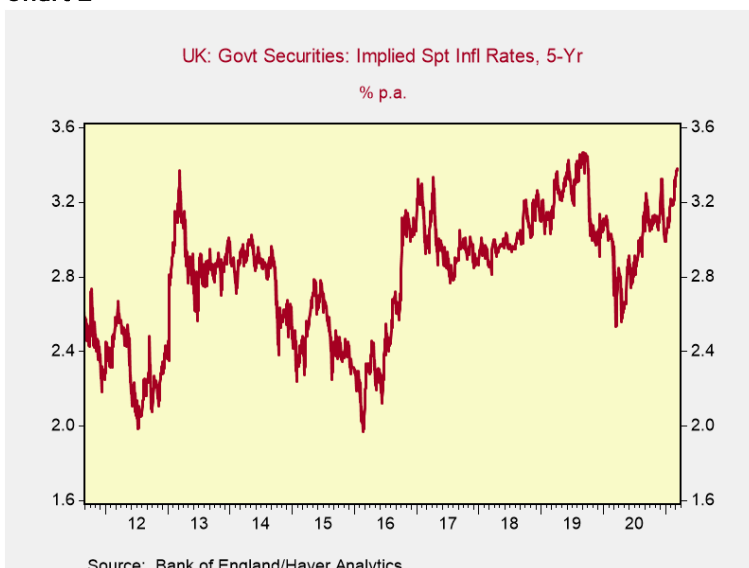
The BoE will likely taper purchases through the second half of the year. With a pace of £2.2bn per week during Q3 and £1.1bn during Q4, the BoE would hit its target during the last week of December.

In 2022, we expect the BoE to remain on hold while outlining its strategy for tightening monetary policy in the years ahead. We expect the first rate hike from its current historic low of 0.1% to come in 2023. However, with its vastly expanded toolkit – including credit policies and macro-prudential tools – the first steps towards a tighter monetary and financial policy may come as early as 2022 ahead of the first rate hike.

Chart 1



Chart 2





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Chart 3

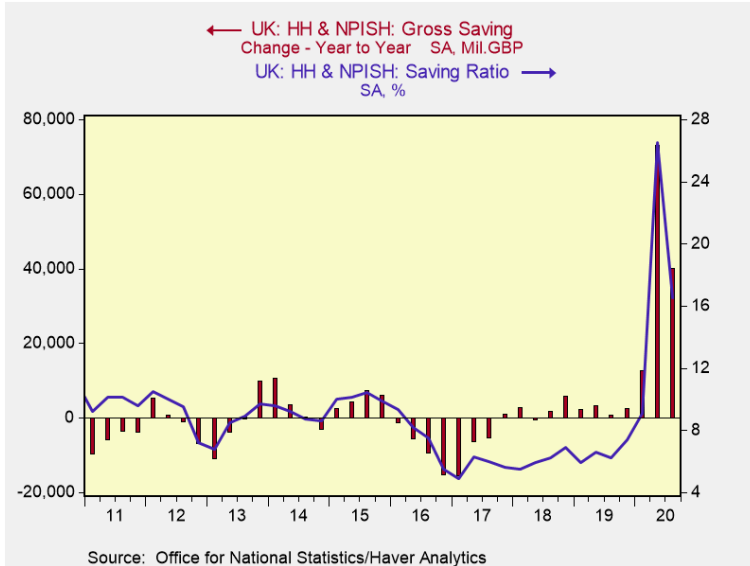
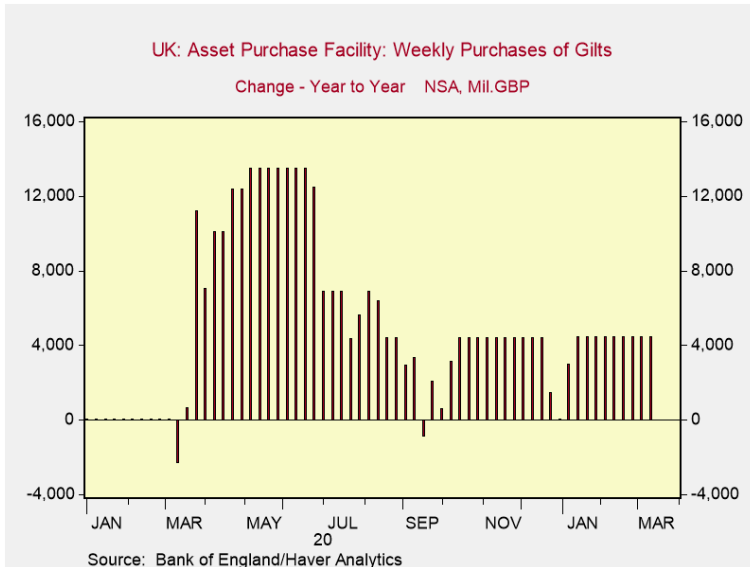


Chart 4





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