GENERALI INVESTMENTS

Focal Point

BoE on hold – pushing back market expectations

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Our Focal Point series explores topical issues on macro, markets and investment

- The BoE's Monetary Policy Committee (MPC) delivered a dovish surprise last Thursday. Contrary to strong market (and our weak) expectations, it kept Bank Rate constant at 0.1%. It also maintained its QE programme.
- While the decision was a strong push-back to elevated market expectations, the bank kept the prospect of a key rate hike "over coming months" alive. We see a first rate hike in December (by 15 bps) but do not expect Bank Rate to exceed 0.75% by the end of 2022. Hence, despite correcting in recent days, we regard current market expectations of an increase to 1% by the end of 2022 as still exaggerated.
- Short-dated UK gilts tumbled after the BoE decision and upward momentum is likely to remain low in the face of still exaggerated BoE expectations. By contrast, we see more leeway for the long end of the curve to shift upwards as the end of the BoE's reinvestments will have a lasting effect on the bond supply/demand balance.

The BoE's Monetary Policy Committee delivered a dovish surprise by keeping its monetary policy unchanged last Thursday. The central bank decided (1) to maintain Bank Rate at 0.1% by a majority of 7–2, (2) to keep the stock of non-financial investment-grade corporate bond purchases at £20 bn (unanimously), and (3) to continue with its existing QE programme (to end in December) by a majority of 6–3. (In addition, the BoE will start applying climate criteria to its credit purchases, which we will discuss in a separate report.)

At the same time, Governor Bailey confirmed the view that some modest tightening of monetary policy over the next months will likely be necessary. Unsurprisingly, he explicitly rejected to confirm December 14, rendering February 2022 also feasible. The main reasons for the central bank's decision were given by (1) the need to get more clarity on the impact of the end of the furlough scheme on the labour market, (2) the fact that the monetary policy cannot tackle supply side problems while (3) higher inflation is expected to be temporary.

Indeed, the press conference gave the impression of a rather cautious MPC (which contrasted the hawkish rhetoric over the past weeks). That looks justified as the economy shows signs of a continued post-Covid recovery, mixed with supply-side constraints. Policy implications could be hugely different depending on the diagnosis of what will prevail. Thus, the BoE avoided a positioning that may prove "premature". The MPC seems well aware of "stagflation" risks, as Governor Bailey noted that trying to cool the economy in a period of supply driven inflation would be the 'wrong thing to do'.

Inflation driven by energy and supply side constraints

Realised UK headline inflation was 3.1% yoy, driven up by a post Covid recovery that runs into supply chain disruptions, international bottlenecks, some UK sector-specific outright supply restraints as well as a large increase in energy prices. Especially the impact of the latter is likely to push up inflation further. The bank expects inflation to rise over the next months and to peak around 5% in April 2022. Thereafter, inflation is projected to fall to 3.4% in Q4 2022 and to continue slowing to 1.9% by Q4 2024 under the assumption that the BoE would follow the market prided interest path (see below). These forecasts incorporate rather tough assumptions on energy prices (i.e. to follow the future rates over the next six months and then stay flat). In an alternative scenario, the Bank's energy price path follows exactly the future curves. In this case, inflation is 'around 0.5 pp lower […] in two years' time, and 0.2 pp lower in three years' (Monetary Policy Report, p.10). Given the BoE's tough assumption about energy prices, the consensus and our inflation forecast (below the 3% level in Q4 2022) are lower. However, the BoE faces the following difficulty: (1) The supply side shock implies lower growth combined with higher inflation. Higher inflation already reduces real income and thus demand. (2) In order to reduce this higher inflation the BoE would need to excessively cool the economy. (3) This is not warranted. The BoE only needs to keep an eye on the post-Covid recovery portion of inflation. In sum, it needs only a softer interest hiking path than compared to "misinterpreting" all inflation as caused by the demand side.

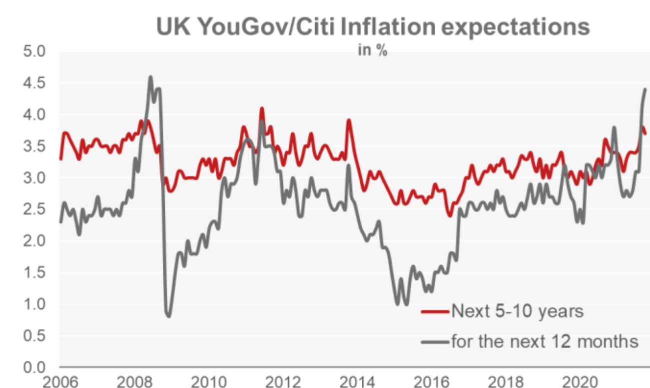
Medium-term inflation expectation well anchored

Accordingly, Governor Bailey rightly stressed that the bank can do little to cut inflation in the near term. Looking ahead, the supply side bottlenecks are expected to ease, provided that Covid will remain in check. But inflation could well be affected if high inflation expectations became entrenched. In October, a Citigroup/YouGov survey suggested a marked increase. Expectations for the next 12 months reached 4.4%, the highest level since 2008 while long-term expectations rose only moderately. The Bank looks at a broader set of indicators. It also argues that only longer-term forecast really matter. While the MPC judged that medium-term inflation remains well anchored, "for inflation to return to target in a timeframe that should help to keep medium-term inflation expectations anchored, [this] will require Bank Rate to rise".

Labour market expected to smooth out

The BoE sees uncertainties in the labour market as the major reason not to hike rates immediately. The latest available figures (November 4) for the Coronavirus Job Retention Scheme (CJRS) shows "that when it closed on 30 September, the CJRS was supporting 410K employers who had a total of 1.14 m jobs on furlough. This is a decrease of 210K employments from 31 August [..]" The BoE cites high frequency indicators suggesting that there has not been a material increase in redundancies since then. Meanwhile, labour market data tightened further. LFS employment in the three months to August (+235K) contributed to a decrease in the unemployment rate in July to 4.5% which is still higher than the pre-crisis levels of just below 4%. Vacant positions are at a record high of 1.1 m, suggesting demand for workers will remain high. The BoE expects unemployment to remain at 4.5% in Q4, before falling back in early 2022. Meanwhile, wage growth (that is very much distorted by the furlough schemes and in the composition of employment) has started to slow from 8.3% in July to 7.3% in August. The Bank estimates underlying wage growth at 4.5% yoy and to remain around 4% in the near term, a bit higher than pre-Covid.

The "bigger" picture is that (compared to pre-Covid) higher unemployment comes alongside higher wage growth. This could be a sign of stagflationary tendencies. Although there is little evidence that labour supply has shrunk at a national level, sectoral and regional matching difficulties (which the bank extensively discusses) can well bear similar effects. The Bank does not connect the wage increase to risks of a wage-price spiral and the 4% figure does not play a larger role. Instead, it states regarding its 2% inflation target, "there will be occasions when inflation will depart from the target as a result of shocks and disturbances". Thus; the MPC looks well aware not to mix up a change in relative prices (wages) with wage inflation. To get more clarity on this point prompted the MPC to delay its first rate hike.



Source: datastream

BoE scenarios

Projections based on market interest rate expectations				
in %	2021 Q4	2022 Q4	2023 Q4	2024 Q4
Central projection				
GDP	6.7	2.9	1.1	0.9
CPI inflation	4.3	3.4	2.2	1.9
Alternative scenario				
GDP	6.7	2.9	1.4	1.1
CPI inflation	4.3	3.4	1.7	1.7
Projections based on constant interest rate expectations				
in %	2021 Q4	2022 Q4	2023 Q4	2024 Q4
Central projection				
GDP	6.8	3.6	1.5	1.0
CPI inflation	4.4	3.8	2.8	2.6
Alternative scenario				
GDP	6.8	3.7	1.8	1.2
CPI inflation	4.4	3.7	2.3	2.3

Source: BoE

Market inflation expectations pushed back

What does this mean for the Banks hiking cycle? Regarding the starting point, there will be two official labour market data sets before the December meeting. Assuming the reports confirm the BoE's benign views, a rate hike in December (by 15 bps in our view) looks more likely than in February 2022.

Regarding the hiking path, the BoE provided several scenarios. Typically, it performs its standard projections based on market interest expectations, i.e. currently a hiking path to 1% by the end of 2022. However, alternatively it held the current Bank Rate of 0.1% constant. On top, it combined these two versions with the standard and alternative scenario for energy inflation described above. The outcome is shown in the table above. By Q4 2024, the market hiking path guarantees CPI inflation to return below the 2% inflation target, while a constant Bank Rate fails to deliver. Thus, some rate hikes will be necessary. However, Gov. Bailey cautioned against views on the scale of an [interest rate] increase that would be likely to push inflation below target in future by increasing slack in the economy". Thus with 1.9% yoy resp 1.7% yoy in Q4 2024, the 1% hiking path delivers results that are deemed too strong. This confirms our view that Bank Rate will stay below 1% and not exceed 0.75% by the end of 2022. Risks are likely rather tilted to the downside.

Still too much priced at the short end of the curve

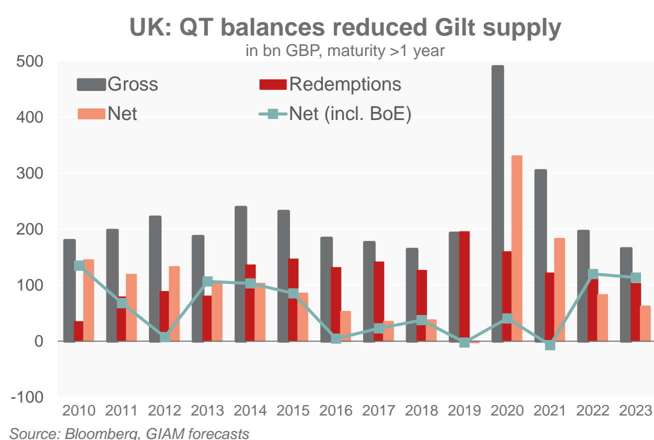
After trading above 0.7%, 2-year UK Gilts fell strongly in the aftermath of the BoE meeting to 0.4% while GBP plunged. This is the result of significantly lower key rate expectations. While before the meeting a Bank Rate of 1.25% was priced amid hawkish comments by the BoE in the run up to the central bank meeting meanwhile a level of only 1.0% until the end of 2022 is discounted. However, for the reasons set out above we regard even current reduced expectations as overdone. Accordingly, the upward momentum for short-dated UK yields is forecast to remain rather low. While a further decrease in short-dated UK yields is not on the cards the expected (further) scaling back of future key rate hikes will cap the rise in yields. On a 1-year horizon we forecast 2-year Gilt yields to reach not more than 0.75%.

Reduced UK Gilt supply only a short-term relief

By contrast, amid the inflationary pressure the long end of the curve has ample leeway to shift upwards and the recent drop of 10-year yields below 0.90% looks disproportionately. Inflation expectations are not yet adequately priced. 10-year UK inflation swaps have reached 4.0% thereby even overtaking 5-year 5-year forward inflation swaps. Although this signals an expected (very shallow) easing of inflation further down the road 5-year 5-year inflation swaps are way above the BoE's target and on the highest level since 2009, thereby indicating persistently high inflation expectations.

Surging inflation expectations pushed real yields far into negative territory. Real 10-year UK yields are currently trading at -3.1%. This is not only well below the US level of -1.1% but even lower than the real 10-year Bund yield level (-2.1%).

This level is hardly sustainable, and we expect real long-dated UK yields to rise, going forward. This applies even more as the BoE will terminate its Gilt purchase programme by the end of the year and will not purchase any new Gilts in 2022. This will make the BoE the first major central bank to end its QE programme. What is more, from a key rate level of 0.5% it will stop reinvesting maturing bonds, i.e. Quantitative Tightening (QT) will start. Even considering our more cautious key rate cycle this implies the stock of Gilts held by the BoE will decrease in the years to come. According to our estimates the QT will lead to a reduction of the central bank's balance sheet by around GBP 35bn in 2022 and of more than GBP 50bn in 2023. Therefore, an important supporting factor for the bond market will not only disappear but will turn into the opposite. If history is any guide the end of QE (and even the start of QT) will drive up particularly real yields.



Source: Bloomberg, GIAM forecasts

One important caveat applies, however. Alongside the new budget forecasts the UK Debt Management Office published also new numbers for the Gilt supply. Considering this, we reduced our supply forecast considerably and now see only a gross issuance of less than GBP 200bn in 2022 and GBP 165bn in 2023. This implies a net issuance of a little more than GBP 80bn and GBP 60bn in 2022 and 2023, respectively. Still, bearing in mind the end of reinvestments by the BoE the net-net supply (incl. BoE) will nevertheless rise strongly (see chart).

All in, we expect long-dated Gilt yields to resume the upward trend interrupted by the publication of the new budget. Over the course of one year, we forecast 10-year UK yields to rise to 1.40%. Given our more cautious outlook for short-dated Gilts, the 2-year/10-year curve is seen to re-steepen again.

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