

# Focal Point

## BoE in hiking mode

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

- After the Monetary Policy Committee raised Bank Rate to 0.5% in early February, we see the BoE to continue hiking its key rate to 1.5% this year. Inflation risks are still tilted somewhat to the upside. However; the BoE model does not only predict to get inflation back under control but also growth to slow substantially over the medium term.
- The bulk of the Gilt sell-off is over. Aggressive rate hikes pricing will limit any further yield increase at the short end of the curve, but Quantitative Tightening (QT) allows for a moderate yield increase at the long end.
- The British Pound credit market can withstand the flows of bonds coming off the BoE's balance sheet, thanks to decent technicals. Long-dated bonds and climate laggards should be the segments most under pressure.

Against the background of substantial upward revisions in its inflation forecast since last November, the BoE's Monetary Policy Committee (MPC) raised Bank Rate again in early February by 25 bps to 0.5%. Reaching the previously set threshold, the MPC also voted to begin to reduce the stock of UK government bonds by ceasing to reinvest maturing assets. Moreover, the Committee's decision contained two hawkish surprises: Firstly, four members of the MPC voted for a stronger 50 bps hike. Secondly, the BoE announced to also end the reinvestment of the £20 bn holdings of non-financial investment-grade corporate bonds. These surprises prompted markets to price in even more rate hikes. However, at the time of writing, OIS implied rates showed strong fluctuations. They temporarily rose to 2.3% by August 2023, but then corrected to 1.8% by the turn of the year and 2.0% in mid-2023. By contrast, economists' views, as expressed by recent Reuters consensus (Feb 14), are much

more moderate. They see Bank Rate at 1.0% in Q2 2022 and 1.25% in 2023. Finally, the MPC also reaffirmed that "it will consider beginning the process of actively selling UK government bonds only once Bank Rate has risen to at least 1% and depending on economic circumstances at the time". We will take up these three topics in turn. We first discuss the macroeconomic elements of the BoE's rate-hiking path, followed by the market impact of rate hikes and the end of reinvestment resp. Quantitative Tightening (QT) on Gilts and corporate bond yields.

#### BoE model suggests Bank Rate rise to 1.25% in 2022

As usual, the MPC's current intentions for the policy outlook can best be captured relative to the BoE macroeconomic model projections. As input, the model uses the (now outdated) market OIS implied Bank Rate hiking path (i.e., an increase to around 1.5% by the middle of 2023) and two

alternative assumptions on oil/energy prices, mainly derived from forward curves.

The model projections show that in the main scenario, CPI inflation would remain high until Q1 2023 (5.2% yoy), but then fall back quickly, slowing to 1.6% yoy over the medium-term forecast horizon. GDP growth would weaken to 0.9% yoy in Q1 2025 and the output gap would increase from a current excess demand to an excess supply of 1 pp of GDP. In the alternative scenario, CPI inflation would diminish even more rapidly to 1.2% yoy. On the labour market, the unemployment rate would rise to 5%, average weekly earnings soften to 2.25% while real post-tax labour income growth would see two years of losses.

### BoE Model projections February 2022

Central projection	Q1 2022	Q1 2023	Q1 2024	Q1 2025
CPI	5.70	5.20	2.10	1.60
GDP	7.80	1.80	1.10	0.90
Excess supply (-)/ excess demand (+)	+0.5	-0.25	-0.50	-1.00
Alternative projection	Q1 2022	Q1 2023	Q1 2024	Q1 2025
CPI	5.70	5.10	1.20	1.20
Annual projections	2022	2023	2024	
GDP growth	3.75	1.25	1.00	
Real post-tax labour income	-2.00	-0.50	0.75	
Unemployment rate (in Q4)	4.00	4.50	5.00	

Source: Bank of England Inflation Report Nov. 2022, GIAM

The model projections suggest that relative to the OIS Bank Rate path to 1.5%, the MPC could have room to be a bit more cautious as inflation falls below the target of 2% combined with subdued growth: Thus, based on these model projections, the MPC could already see a Bank Rate increase to 1.25% as sufficient. Accordingly, the MPC judges that “[...] some further modest tightening in monetary policy is likely to be appropriate in the coming months.” However, compared to the November Inflation Report, the MPC added the word “modest,” thereby suggesting limited action.

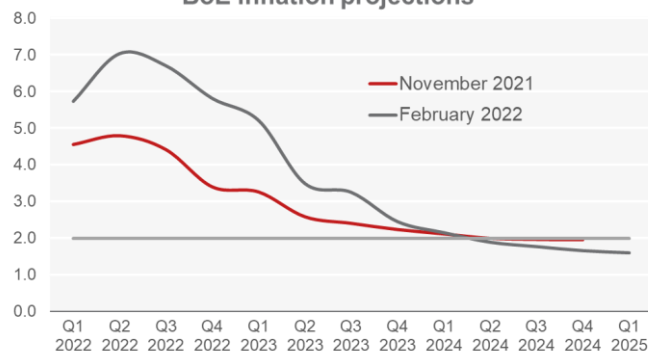
### Why is the market path so much steeper?

However, the model suggested MPC hiking path differs significantly from market expectations. We discuss the pros and cons in order to draw conclusions for our scenario. We see three main topics:

Firstly, the market could be temporarily carried away given the recent strong fluctuations.

Secondly, markets may discount that inflation risks are still tilted to the upside. Support for this view could come from recent revisions, which forced the BoE to raise the inflation peak projection by 2 pp compared to the November report to now 7.25% yoy in next April. The main reasons were higher energy/commodity prices as well as tradable goods prices,

### BoE inflation projections



Source: Bank of England, GIAM

induced by more persistent supply bottlenecks. By that time, the BoE assumption were not unreasonable (energy prices were markets futures curves) and broadly shared by consensus and us. However, such an underestimation could again materialise given the Ukraine conflict and the Omicron risks on supply chains in Asia. Domestically, the 54% rise of the energy regulator Ofgem’s (Office of Gas & Electricity Market) utility price cap on April 1<sup>st</sup> will have an inflationary effect. While the inflation report already mentions this decision, it remains unclear how much it has been factored in. Other risks are more strongly rising food prices. More and more reports suggest ongoing price risks on poor harvests, labour shortages, and rising global food prices. Rising rents are another risk factor. Overall, the April peak could well come in even above the 7.25% expected by the BoE. However, with an inflation projection of 5.2% in Q1 2023, the BoE is clearly on the hawkish side of current forecasts. The consensus forecast for that quarter is only at 3.7% yoy.

Thirdly, markets could see the negative impact of inflation on GDP growth less severe and thus also a wage-price spiral as more likely. However, the cost-push part of current inflation (e.g., energy, supply chains, food, Brexit) already contains a stagflation impact on the economy. This is less visible due to the overlay from the post-Covid-recovery. Nevertheless, the implied loss in real income is unavoidable. To limit inflation, the BoE additionally bites into demand, stating: “[...] that the inflation target applies at all times, [...]” The BoE model clearly shows the negative results of both mechanisms on GDP, lowering growth to 1.25% (2023) and 1% (2024). This compares to the consensus growth forecast of 2.1% resp 1.7%.

Given the discussions above, we see the mixture of risks for inflation to be still tilted somewhat to the upside especially in H1 2022. Overall, we see inflation at 6.1% this year (consensus 5.2%) and 2.6% (consensus 2.4%) in the next. In 2024, inflation could fall to 1.6%. Consequently, we see growth lower than consensus this year at 3.7% (consensus 4.3%) and 2023 at 1.6% (consensus 2.1%). For 2023, we

stay above the BoE forecast as we see inflation risks more concentrated near term. As a consequence, we expect the MPC to hike Bank Rate to 1.5% by consecutive four 25 bps rate hikes in March, May, August, and November. As inflation slows below target on the medium term and further Bank Rate increases the recession risk, we expect the MPC to pause at least for total 2023.

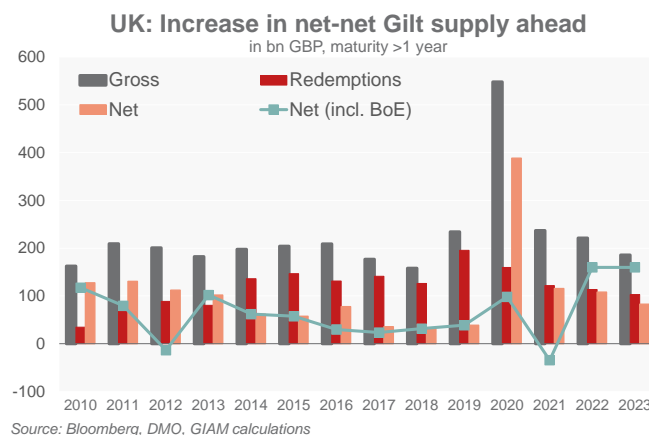
The BoE will start considering active QT when Bank Rate reaches 1% in May. The BoE denied any automatism but made it dependent on the circumstances. As it lacks precedent, there is high uncertainty. Governor Bailey said recently, “we would not do QT during a period of financial instability.” We see an official market consultation as likely. De-facto selling could start in August with a very limited level of £0.5 bn to £1 bn per week.

### Flattening of Gilt curve has gone too far

Since mid of December 2021, UK Gilts have been among the worst-performing government bonds of developed countries. Elevated inflation and the BoE’s hawkish rhetoric have triggered a strong sell-off across the curve. However, as described above, we regard the current market pricing of key rate hikes to around 2.0% until the beginning of 2023 (and roughly constant over the course of 2023) as exaggerated. These key rate levels imply a further significant increase in short-dated UK yields. Discounting current market expectations implies another rise of around 50 bps for 2-year UK yields to 1.80%. This applies even more as financial markets consider the balance of risks given upward surprising inflation rates in recent months. However, we doubt that there is much leeway for short-dated yields to rise. Notwithstanding a temporary overshooting amid upside risks on inflation in the near term, we do not see further sustainable upside potential and forecast 2-year UK yields to finish the year moderately above current levels (1.50%).

On the contrary, we see some further upside potential for long-dated UK yields. To start with, the expected yield rise in the US (and in the euro area) will also pull long-dated UK yields upwards. Moreover, from now on, the BoE will not reinvest maturing Gilts. This implies that throughout 2022 circa £37 bn will not be reinvested and an even slightly higher volume next year. Moreover, the BoE will start actively selling Gilts (QT), depending on the data. We assume that they sell an amount of £3 bn each month. This translates into a further balance sheet reduction of £15 bn and £39 bn in 2022 and 2023, respectively. Although net supply will shrink moderately in the years to come, financial markets will have to absorb almost £160 bn this year and next. This deterioration of the technical situation is seen to impact particularly long-dated Gilts. As a result, we forecast 10-year UK yields to reach 1.70% until year-end (currently 1.45%) despite the cautious growth outlook and the forecast

correction of the financial market’s key rate outlook.



Generally, financial market participants should prepare for a period of increased volatility as expectations will change according to the data flow and the news from the BoE. Nevertheless, we see the 2-yr/10-yr yield curve to eventually re-steepen to 25 bps by year end (forwards see the 2-yr/10-yr gap to remain around current levels of 10 bps).

### The credit market should withstand pressure

On 3 February, the BoE took markets by surprise in announcing that it will start to sell its £20bn holding of corporate bonds as part of their quantitative tightening process. The technical details remain unknown, but we expect to receive technical details 15 to 30 days before the first sale begins. The most recent example we have comes from the US. The Federal Reserve has begun selling down its Secondary Market Corporate Credit Facility (SMCCF) from June 2021 up until September 2021. Compared to the size of the market, the holding of the Fed was much smaller than in the UK, and it didn’t prevent US credit spreads from holding tight.

In the UK, we believe that the pound credit market can withstand the flows of bonds coming off the BoE’s balance sheet although it will add to an already growing supply. The market has already grown by £10bn over the last few years and the initial reaction to the quantitative tightening was unwound pretty quickly showing the strong resilience of this market dominated by Insurance companies with very strong buy and hold bias. Primary issuances might be reduced thanks to reduced appetite from international issuers. Hence, we expect the correlation to the Euro market to remain high, and spreads to remain flat to marginally wider by year end. In terms of market segment, we do not have the exact details of what the BoE is holding, but they are overweight in long-dated bonds, which may be suffer most near term. Moreover, following the announcement of the climate strategy (see our market commentary), we believe the BoE will start selling the climate laggards first.

## IMPRINT

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