Focal Point
Labour market key for BoE's first rate hike

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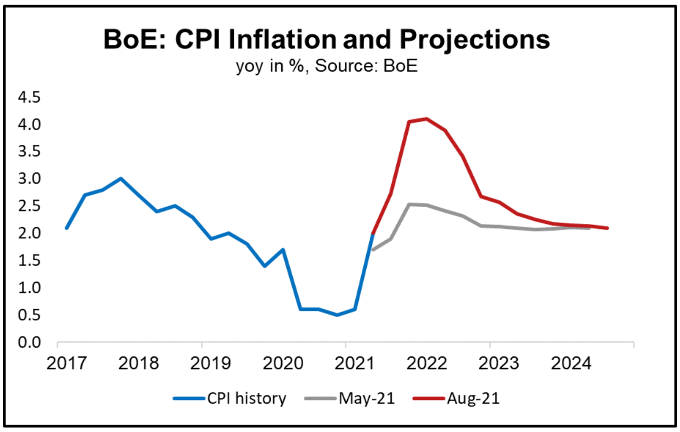
- In early August, the Bank of England's (BoE) Monetary Policy Committee (MPC) judged that 'some modest tightening of monetary policy over the forecast period was likely to be necessary'.
- While it sees inflation to temporarily spike to 4%, the ultimate reason for the BoE's more hawkish policy approach is the labour market. Its recent strength could cause the Covid recovery-related inflation spike to become entrenched.
- Given the rather tough message of the BoE, we expect a first rate hike by 15 bps in August 2022, to be followed by another 25 bps key rate hike in Q2 2023. We anticipate the QE programme to end in December. According to the new BoE criteria, it will stop reinvesting maturing Gilts at Bank Rate of 0.5%, i.e. at the time of the second key rate hike
- Notwithstanding the BoE's more hawkish stance, we regard the currently priced first key rate hike for Q2 2022 as a little overdone and see only limited upside potential for short-dated yields. In contrast, long-dated UK Gilts appear vulnerable to the forthcoming end of Quantitative Easing and a bearish turn in global bond market sentiment.

In early August, the Bank of England's (BoE) Monetary Policy Committee (MPC) judged that 'some modest tightening of monetary policy over the forecast period was likely to be necessary' should the economy evolve broadly in line with its projections. The MPC thus continued its relatively hawkish stance, but left its powder dry on the exact timing of a first rate hike. Based on OIS implied rates, in the week following the MPC meeting, markets brought forward the first expected hike to Q2 2022 from Q4 2022 previously. By contrast, economists in the financial sector remained very much divided. Views range from Q1 2022 to Q3 2023, but are tilted towards a later lift-off.

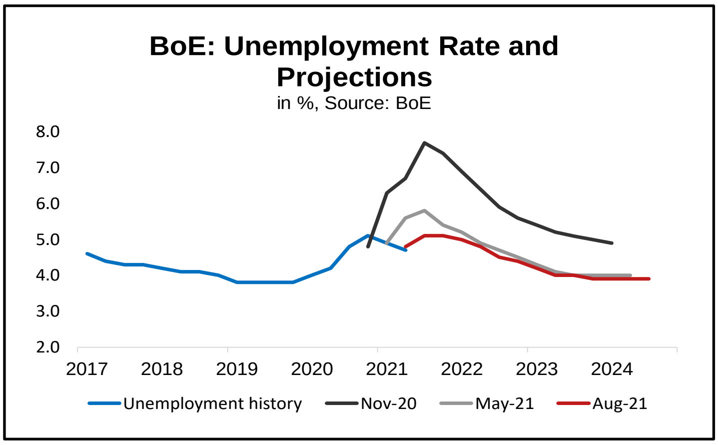
BoE expects inflation to reach shortly 4%

The large discrepancies in expectations are mainly caused by different views about the development of the labour market, but other factors like inflation and growth also play a role. The recent inflation spike is a prime cause for concern. CPI inflation rose to 2.5% yoy in June, and has constantly surprised the upside over the last months. Core CPI inflation has also risen to 2.3% yoy. However, July inflation surprised on the downside with 2% yoy, which is widely considered just a "blip". Generally, the CPI development over the last months outpaced previous MPC's forecasts, which were consequently revised up rather markedly. The BoE now expects a temporary inflation rise in the "near term to 4% in 2021 Q4, owing largely to developments in energy and other goods prices." However, the Committee also judges that inflation will fall back to the 2% target in the medium term and is willing to look through these post-Covid fluctuations. Thus, the MPC is not too worried by this temporary breach of its inflation target by itself.



Labour market development the key risk factor

But Governor Andrew Bailey flagged lingering concerns in the background in the press conference in early August, saying that 'the challenge of avoiding a steep rise in unemployment has been replaced by that of ensuring a flow of labour into jobs'. The labour market could recover faster than previously assumed, and the BoE has lowered its unemployment forecast significantly (see graph next page). It now expects unemployment to peak at 5.1% already in Q3 2021. That is much more optimistic than the 5.8% projection in May. Given this outlook, the BoE is worried that a rapid labour market improvement may reduce slack quickly. Labour shortages could then contribute to inflation becoming entrenched over the medium-term. Thus, the more hawkish tone.



Response to end of furlough scheme unclear

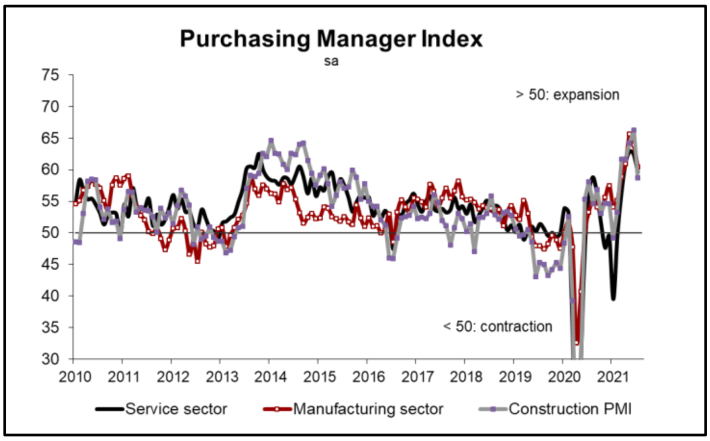
The outlook for the labour market is as decisive for the timing of the first rate hike as it is difficult to judge. Labour market data clearly improved substantially over the last months. The ILO unemployment rate fell to 4.8% in June. The MPC mentions private sector regular pay which was 'over 7% higher than a year earlier' in the three months to May and annual growth is projected to have peaked at around 8½% in 2021 Q2." Latest data show average earnings in the three months through June surging to a record 8.8% yoy.

These measures of pay growth are being distorted by the Covid-19 crisis but the exact extent is hard to pin down. Adjusted for the impact of the furlough scheme, the changing composition of employment during the pandemic and annual base effects, the BoE sees underlying pay growth 'to continue to be around pre-Covid rates'. In May and April last year, when the furlough schemes were introduced for many workers, they received 80% of their pay, which reduced the level of average earnings. Now, with people coming out of this scheme, the low base results in artificially high pay rises. Moreover, there is a composition effect involved, as low paid jobs were hit disproportionally strongly during the crisis. A KPMG/REC survey finds that job placements barely dipped from the record levels in June and took off in previously weaker parts of the country, especially in London, where Covid-19 had hit employment the hardest. Staff availability is low and companies in all sectors are facing severe recruitment difficulties (see also FT: How the hot UK labour market is driving interest rate forecasts).

The litmus test to labour market stability will come at the end of September, when the UK furlough scheme expires. Latest figures for the Coronavirus Job Retention Scheme (CJRS) show that there were 540,000 employers with 1.9 million staff on furlough on 30 June 2021. It is unclear how many of these people can go back to their previous jobs. The discussion is also touching on the topic of a wider 'reconfiguration' of post-Covid economies (sectoral restructuring) which also takes place in other countries. Overall, the BoE looks rather optimistic. Accordingly, 'the MPC judges that spare capacity has been eroded over the past couple of quarters' […] while 'there is uncertainty around these judgements, including how the economy will adjust to the end of the furlough scheme.' No, or little spare capacity markedly increases the risk of sustained inflation.

BoE's GDP growth forecast is optimistic

The BoE's growth forecasts support this judgement of limited slack in the economy. UK GDP grew by 4.8% qoq in Q2 which was a little below the BoE's 5.0% qoq assumption from early August. The MPC is also rather bullish on the near-term Q3 forecast with a 2.9% qoq, assuming that the spread of the delta variant of the Coivd-19 virus will have no major repercussions. All in, the BoE expects GDP growth at 7.25% in 2021 and 6.0% in 2022, well above Reuters consensus forecast of 6.7% in 2021, 5.2% in 2022 and 1.9% in 2023. Consensus is also less optimistic on Q3 with 2.5% qoq. Clearly, the UK economy is likely past the top of the recovery dynamics. The composite PMI receded in July by 3 index points to 59.2, which is still a very high level. The slowing was driven mainly by the new orders component but also by output. The employment component also eased by about two index points to 56.4. We see UK growth at 7.0% this year and 4.9% in the next, being a bit more reluctant in 2022 as fiscal consolidation has been announced to start.



First rate hike expected in summer 2022

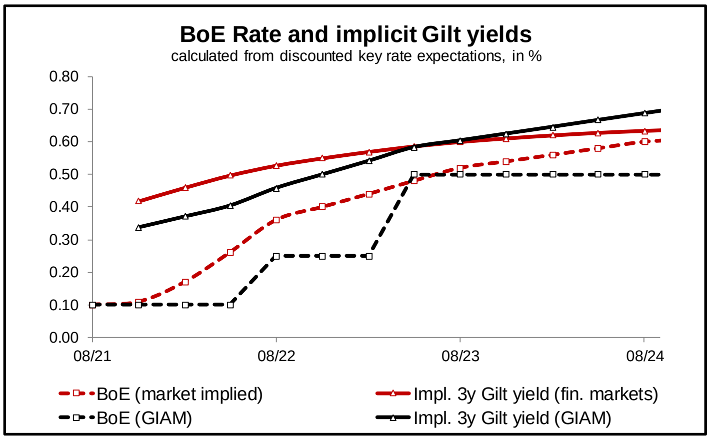
Moreover, we also see inflation a bit higher than consensus, at 2.2% in 2021 (consensus 1.8%) and 2.5% in 2022 (2.2%). While we are more sceptical with regard to the labour market and the Covid-19 situation, we see the mood in the MPC more tilted to the hawkish side. Currently only one MPC member (Michael Saunders) already thinks that the conditions for tightening have been met to a degree that justifies policy action. Accordingly, he voted to reduce the QE program to a target to GBP 830bn and to end net purchases in September. We see no majority for an early ending of QE until the end of the year. Nevertheless, the group who thinks the conditions for tightening have been met but are just not yet sufficient to trigger policy action seems to be rising. All in, we see a first policy hike in August 2022 by 15 bps to 0.25%, followed by a 25 bps increase in Q2 2023. The MPC statement of a 'modest' policy action is widely interpreted in a way that the Committee will not drive Bank Rate past 0.5% over the forecast horizon.

Moreover, the BoE modified existing thresholds regarding QE. It will stop reinvesting maturing assets when Bank Rate has risen to 0.5% and start active Gilt sales when it reaches 1%. The reduction to 0.5% (in 2018 the BoE had said it would keep reinvesting until Bank Rate reached at least 1.5%) has provoked speculation that the BoE implicitly also cut its terminal rate, but this would also imply an unusual strong cut in the productivity forecast, which we doubt. According to our forecast, this 0.5% threshold will be reached in summer 2023. While the profile of maturing Gilts is somewhat uneven, the BoEs balance sheet could shrink with an average yearly runoff of around £50bn.

Limited leeway for higher short-dated yields

The BoE's statement initially triggered a moderate increase in UK yields across the curve (up to 10 bps), but since then yields have dipped again. In the following we will show that the medium-term outlook for different tenors differs.

As highlighted above, we regard the current pricing for a first key rate hike as a little too ambitious. The chart below shows that the current market expectations imply an increase of 3-year UK yields to around 0.5% on a one-year horizon. While the approaching of the tightening cycle will drive short-dated yields up, this impact will be limited to a modest ~10 bps push to 3-year yields. Considering a current trading moderately below the fair value we expect 3-year yields to rise to not more than 0.4%.

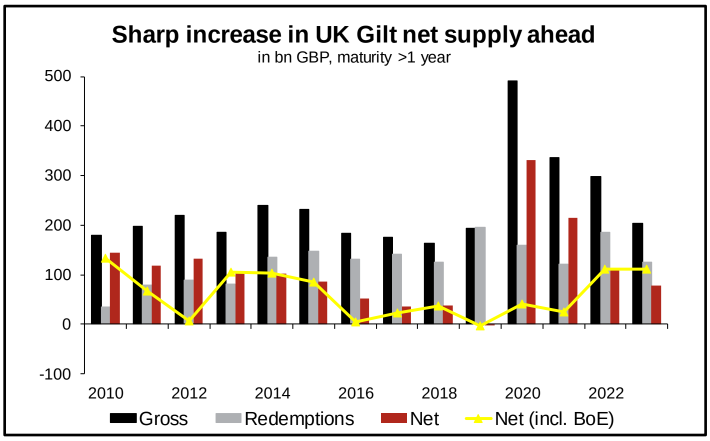


Given the BoE's statement the risks to this forecast are on the downside. First, the central bank decided to continue its QE programme as scheduled and to keep weekly purchases at GBP 3.4bn per week until mid-December. While a decision to end the QE programme early is still possible the probability of this appears low amid the current voting behaviour. Second, the medium-term outlook for inflation is rather benign. While the BoE acknowledged the near-term overshooting of inflation, it even lowered the inflation forecast on a 3-year horizon slightly to 1.9%. This does not indicate a strong hiking pressure and balances the more hawkish news regarding the downward revision of the key rate level at which the central bank will stop reinvestments. Overall, there is a certain likelihood that financial markets will adjust current key rate expectations in the coming months reducing the upward potential for short-dated yields.

Imminent end of QE to drive up long-dated yields

In contrast, we see considerable upside potential for longer-dated yields. The two main arguments relate to the coming end of QE and the global interest rate connection.

The BoE is expected to complete its purchases of Gilts by mid of December. This has been a strong support since the start of the Covid-19 pandemic and will continue to do so for the remainder of the year. The BoE's purchases are likely to match the expected supply until December 2021 (GBP 65bn vs. GBP 62bn). However, this will change noticeably next year. Financing needs will come down from more than GBP 200bn this year to around GBP 110bn in 2022. But the missing purchases by the BoE will effectively lead to a greater take-up by the bond market. The net-net supply (including BoE's purchases) will rise from around GBP 20bn in 2021 to more than GBP 110bn in 2022 (the highest level since 2010). The technical situation is unlikely to improve in 2023. A key rate at 0.5% implies the BoE will effectively start Quantitative Tightening (stop reinvesting maturing assets to achieve a reduction of the central bank's balance sheet). Hence, assuming the BoE will lift the key rate in mid-2023 means around GBP 35bn will not be reinvested in Q3 2023. Consequently, despite a further decline in financing requirements, the net-net supply will remain largely constant on a very high level in 2023 (see chart below). While active selling of Gilts is not yet on the cards (only considered once the key rate reaches 1.0%), markets may focus soon on the looming wall of supply.



Additionally, it appears that yields have bottomed, and we see leeway for moderately rising yields globally. While the emergence of new virus variants has increased uncertainty and sentiment indicators have peaked, surveys are still consistent with economies growing well above potential. Furthermore, the end of stealth QE in the US (reduction of Treasury cash balance) and a more balanced seasonal pattern after the summer break points to higher yields as well. Finally, current yield levels (particularly real ones) are well below fair values and do not look sustainable. All in, we forecast global yields to increase going forward which is seen to drive up long-dated UK yields as well (1.0% on a 12-month horizon).

In case the risk scenario materialises and the unemployment rate has already peaked and/or inflation turns out to be more permanent, the BoE might hike sooner than Q2 2022. This would run counter to the expected yield curve steepening but would further intensify the predicted bearish bond market environment (even active selling of Gilts cannot be excluded).

The initial appreciation of the GBP after the BoE's decision has turned out to be temporary. Given a vanishing vaccination lead of the UK, eroded post-Brexit appeal and a persistent C/A deficit, we do not anticipate any protracted rally in sterling. That said, pencilling in an earlier BoE move and a cemented dovish stance by the ECB, we mildly lower our EUR/GBP forecasts to 0.85 3m (sideways) and 0.86 12m.

Imprint

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