Bank of England put negative rates on the long finger

11 February 2021

IN BRIEF

- The Bank of England (BoE) has postponed a decision on negative interest rates for at least six months with the probability of negative rates declining sharply due to the expectation of a strong vaccine-led recovery.
- The UK's rapid vaccination rollout will allow an easing of the current lockdowns in the coming months, triggering a strong rebound in consumer spending and employment, according to the updated forecasts in the BoE's latest Monetary Policy Report (MPR).
- A disciplined approach to cash segmentation, prioritizing a combination of money market and ultra-short duration funds, should allow investors to optimise returns without excessively increasing risk or volatility.

THE BANK OF ENGLAND'S DECISIVE INDECISION

After several weeks of market debate on the benefits and disadvantages of negative interest rates, the BoE decided to further postpone a decision for at least six months until the UK's financial markets can implement the necessary tactical changes to accommodate such a dramatic move. However, with the central bank also forecasting a strong, vaccine-led recovery, the probability of negative rates being introduced has declined sharply – with significant implications for cash investors.

A UNANIMOUS DECISION

At their first Monetary Policy Committee (MPC) meeting of 2021 on 4 February, the BoE voted unanimously to keep the Bank Rate unchanged at 0.10% and maintain the total target of asset purchases at GBP 895 billion (GBP 875 billion of government bonds and GBP 20 billion of corporate bonds).

This decision was in line with expectations, however, the tone of the accompanying minutes and subsequent comments by Governor Bailey were surprisingly hawkish. Despite a worse-than-expected start to 2021, the updated forecasts in the BoE's Monetary Policy Report suggests the UK's rapid vaccination rollout will allow an easing of the current lockdowns in the coming months, triggering a strong rebound in consumer spending and employment. This, the central bank suggests, would allow inflation to reach the MPC's 2% target within two years without any further changes to the Bank Rate (**EXHIBIT 1**), while permitting GDP to recover rapidly towards pre-Covid levels by the end of 2021.

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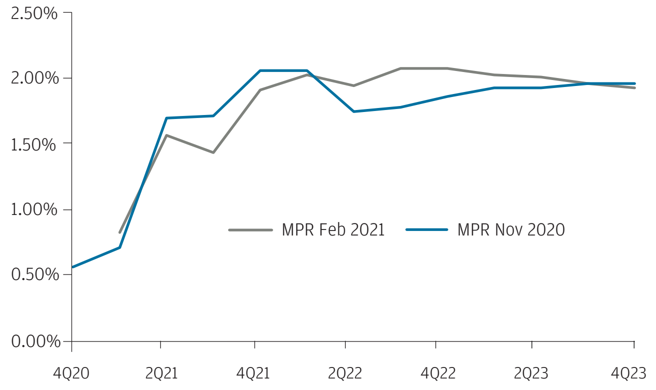
Exhibit 1: Bank of England median CPI forecasts (% year on year, constant rates)



Source: Bank of England, as at 4 February 2021.

NEGATIVE RATES PARKED, FOR NOW

The BoE also published the Prudential Regulatory Authority's (PRA) consultation on negative interest rate policy (NIRP). The report concluded that financial systems required at least six months to implement the necessary tactical changes to deal with a negative Bank Rate.

While the BoE recommended that this work commence immediately in order to add the capability to the MPC's toolkit, it cautioned against interpreting the request as an outright signal that NIRP was likely or indeed imminent. Concurrently, the central bank announced a review of its 2018 exit guidance that asset purchases would not be reduced until the Bank Rate had reached at least 1.50%.

NEVER NEGATIVE?

The MPC's hawkish comments combined with the BoE's upgraded economic forecasts prompted a rapid reappraisal of the likelihood of negative interest rates. Investors unwound expectations of further rate cuts, the GBP Libor curve steepened (**EXHIBIT 2**) and forward SONIA curves also shifted higher (**EXHIBIT 3**).

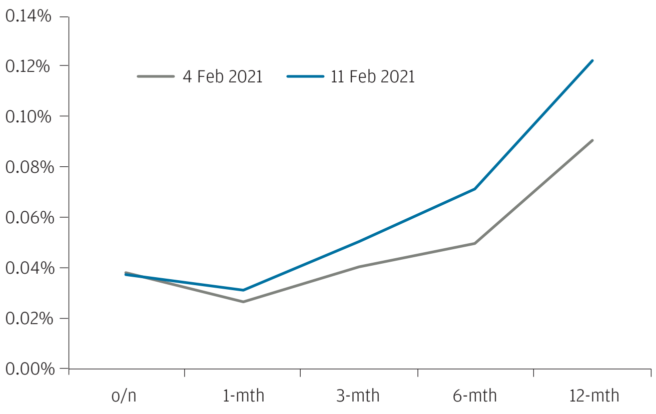
Having weathered the worst economic effects of the Covid-19 pandemic without resorting to negative interest rates, the PRA's six-month NIRP implementation timeframe appears, for the moment, to have abolished any expectations that UK base rates would be proceeded by a minus symbol. Nevertheless, the PRA did distinguish between NIRP and zero interest rate policy, implying rates will remain low for the foreseeable future and could slip lower if there were unanticipated setbacks to the vaccine rollout or the projected recovery.

THE INFLATION PIVOT

The rapid rollout of vaccines has encouraged investors to ignore temporary weakness and focus on the prospects of a strong recovery. This has also prompted a resurgence of inflation concerns.

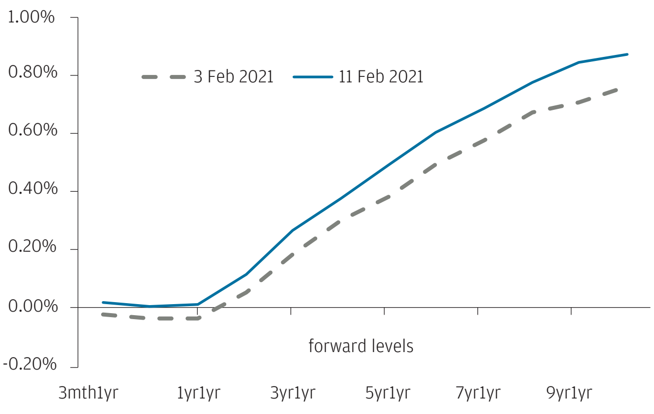
Extremely supportive monetary and fiscal policies have pushed the UK's household saving ratio to a record high. This pent-up demand, combined with the easing of social distancing rules, could generate a sharp increase in aggregate demand and, in turn, inflation.

Exhibit 2: GBP Libor yield curve



Source: Bloomberg, as at 11 February 2021.

Exhibit 3: UK SONIA forward curve



Source: Bloomberg, as at 11 February 2021.

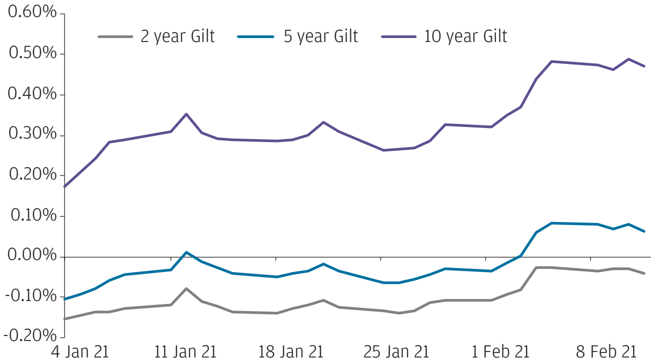
As the lower oil prices and temporary VAT rebates of 2020 roll out of annual numbers, CPI and RPI – exacerbated by a recent index reweighting – could spike higher. Any further recovery in the labour-intensive and inflation-sensitive services sector could further reduce spare capacity prompting a more sustainable increase in CPI towards, and perhaps above, the BoE's target over the coming two- to three-year horizon.

INVESTOR IMPLICATIONS

UK cash Investors have experienced challenging investment conditions since the BoE's rapid rate cuts in March 2020, while the prospect of negative interest rates remained a constant concern. The surprise news that the BoE has pivoted to a very positive economic outlook has, at least temporarily, removed the downside risk of negative returns, while raising expectations of rate hikes and higher cash returns.

However, the economic outlook remains uncertain with any unanticipated setbacks to the vaccine rollout or the projected recovery likely to prompt a reappraisal by the BoE. This implies the central bank is unlikely to react immediately to higher inflation, preferring to confirm the strength of the recovery before acting, while letting longer-term yields absorb the impact of positive economic news (**EXHIBIT 4**).

Exhibit 4: Yields on long tenor UK bonds



Source: Bloomberg, as at 11 February 2021.

For sterling investors, holding all cash balances in deposits remains an impractical investment strategy. Meanwhile, the risk of capital losses in longer duration strategies has also increased. A disciplined approach to cash segmentation, prioritizing a combination of money market and ultra-short duration funds, should allow investors to optimise returns without excessively increasing risk or volatility.

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