Bank of England upgrades economic forecasts – but let's not get carried away!

20 May 2021

IN BRIEF

- At the latest Bank of England (BoE) monetary policy meeting, the Monetary Policy Committee (MPC) significantly upgraded its economic growth, inflation and employment forecasts.
- The rapid vaccine rollout, dramatic decline in new Covid-19 cases and swift rebound in consumer spending have triggered expectations of a strong economic recovery.
- With bond yields jumping higher and curves steepening, Governor Bailey cautioned that people should "not get carried away" by the strength of the rebound – creating a challenging paradox for Sterling cash investors.

MORE SYMMETRICAL OUTLOOK

Last quarter, the possibility of a negative UK Bank Rate was top of mind for investors. The BoE postponed that decision for at least six months until the UK financial markets could implement tactical changes to accommodate such a move. This quarter, with lockdown restrictions currently easing in line with the government roadmap, optimism is growing that the expected demand-led recovery will make negative short-term interest rates a remote prospect. This positive outlook was reinforced when the BoE upgraded its near-term economic assessments in its latest Monetary Policy Report (MPR). Forward guidance now states that the MPC will "continue to monitor the situation closely and take whatever action is necessary," thereby expressing a more symmetrical outlook, which should have significant implications for cash investors.

UNANIMOUS ON RATES, BUT NOT PURCHASES

The MPC voted unanimously to keep the Bank Rate unchanged at 0.10%. It also agreed to maintain the total target of asset purchases at GBP 895 billion (GBP 875 billion of government bonds and GBP 20 billion of corporate bonds). Unexpectedly, the vote to hold steady the stock of government bonds was decided 8-1, with chief economist Andy Haldane dissenting in favour of an immediate reduction in purchases. Haldane is viewed as one of the more hawkish members of the committee and his lone dissent came as a surprise, but the market did not react materially, likely because his last MPC meeting will be in June. Haldane's departure could tip the BoE towards a more dovish stance, but this will likely be tempered in August when the terms of two more dovish, external members of the committee, Gertjan Vlieghe and Jonathan Haskel, come to an end. In the meantime, the MPC should remain in balance, potentially with a less diverse range of opinions, depending on the three new replacements.

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A TECHNICAL TAPER, NO IMMINENT RATE CHANGES

The BoE also announced that the weekly pace of government bond buying would slow to GBP 3.4 billion per week, a technical adjustment needed in order to finish the current GBP 150 billion programme around year end. Market opinion was divided as to whether tapering would happen now or in August, but the MPC determined that developments in financial conditions since the start of the latest round of purchases, which began in November 2020, warranted an immediate slowing.

With economic activity expected to be boosted by consumption and fiscal measures, growth is expected to recover to pre-Covid levels before the end of the year: 2021 growth is expected at 7.25% (up from the previous forecast in February of 5%), and forecast to reach 5.75% in 2022 before moderating to 1.25% in 2023. Consumer spending should be supported by households deploying up to 10% of their additional accumulated savings, double the previous estimate of 5%. Inflation will temporarily pick up to an average of 2.5% in 2021 before dropping back to just below the 2% target over a two- to three-year time horizon and conditioned on market pricing of an interest rate hike of 50 basis points before the end of 2024 (**EXHIBIT 1**).

Unemployment is projected to peak at 5.4% in 2021 (versus the previous expectation of 7.8%) supported by the extended furlough schemes, but spare capacity is anticipated to remain unchanged. That last point is significant as the MPC "does not intend to tighten monetary policy at least until there is clear evidence of progress in eliminating spare capacity."

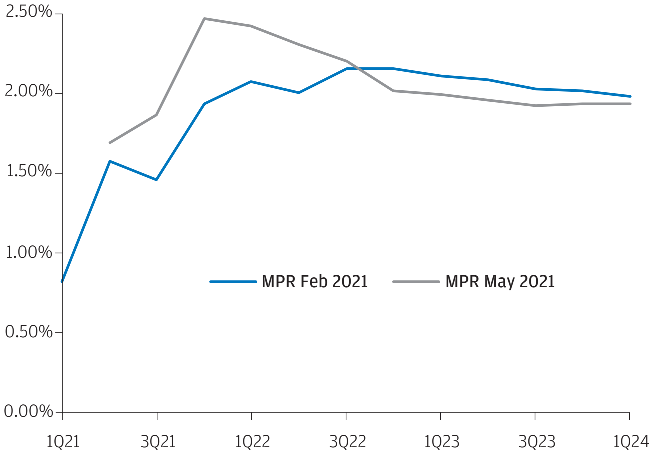
This takes interest rate hikes off the immediate horizon and puts them in line with market pricing, which is currently sometime in 2023. An update to the BoE exit strategy for asset purchases, expected from them later this year, will also give clearer signal on the timing for policy normalisation.

INVESTOR IMPLICATIONS

UK cash investors have experienced challenging investment conditions since the BoE's rapid interest rate cuts in March 2020. While the BoE has upgraded its near-term forecasts, monetary policy remains far from normalised and the medium-term economic outlook remains uncertain, with continued risk of unanticipated setbacks from new virus strains or continued high numbers of cases in India and other countries. The BoE now views the risks as more symmetrical, but will take whatever action is necessary to achieve its remit; therefore it is unlikely to react immediately to higher inflation, preferring to first confirm the strength of the recovery and let longer-term yields absorb the impact of positive economic news.

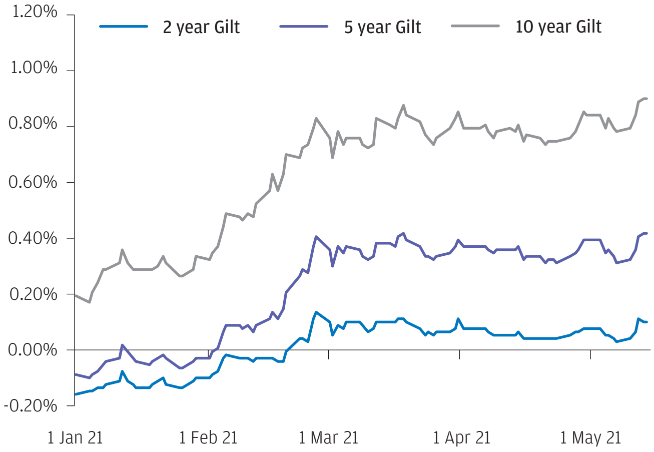
For sterling investors, holding all cash balances in deposits remains an impractical investment strategy while the Bank Rate remains low at 0.10%. The risk of capital losses in longer duration strategies has also increased as longer-term yields have continued on an upward trend since the last MPR in February (**EXHIBIT 2**). A disciplined approach to cash segmentation, prioritising a combination of money market and ultra-short duration bond funds, could help investors to optimise returns without excessively increasing risk or volatility.

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



Source: Bank of England, as at 6 May 2021.

Exhibit 2: Yields on long tenor UK bonds have continued to rise



Source: Bloomberg, as at 14 May 2021.

Past performance is not a reliable indicator of current and future results.

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