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Bank of England lift off with 15bps hike despite Omicron threat

17 December 2021

IN BRIEF

- The Bank of England (BoE) surprised the market – again – as they became the first major central banks to hike policy rates with an 8-1 vote to raise the Bank Rate from 0.1% to 0.25%.
- Concerns around "more persistent" inflation, increasing wage growth and strong, albeit slowing growth were enough to deliver the first rate hike since 2018. Yet, the BoE cautioned about uncertainties due to the rapidly spreading Omicron variant.
- The increase in the Bank Rate will bring welcome respite for cash investors struggling with the challenges posed by ultra-low yields. However further volatility is likely and investors should consider maintaining a disciplined approach to cash segmentation.

The Bank of England (BoE) delivered an early festive surprise for sterling markets as they increased the Bank Rate by 15 basis points (bps) to 0.25% at its December Monetary Policy Committee (MPC) meeting. Concurrently, the MPC voted unanimously to maintain asset purchases at £895 billion (**EXHIBIT 1A**). The increase in rates was small, but the central bank's continued inflation concerns suggests significant implications for short-term cash investors.

WILL THEY? WON'T THEY?

The BoE's efforts to normalise rates is both later and earlier than expected by the markets. As recently as August, the BoE pivoted to a more hawkish policy bias and by November a rate hike was fully priced in due to stronger than expected economic data and hawkish rhetoric from MPC members. However, the BoE hesitated, awaiting additional evidence that the labour market would remain resilient as the furlough support scheme ended, and further insight on the impact of global cost pressures.

Data since then has been broadly in line with the bank's forecasts. The unemployment rate fell to 4.2% in the three months to October and underlying earnings growth was above pre-pandemic levels. Meanwhile, inflation jumped to a decade high of 5.1% in November. However, the rapid spread of the new Omicron variant throughout the UK was viewed as a risk that could cause the BoE to remain on hold until 2022.

WE HAVE LIFT-OFF!

The MPC's decision to raise the Bank Rate to 0.25% was driven by "evidence of a very tight labour market" and "more persistent inflation pressures" which contravened the bank's 2% inflation target.

The BoE recognised that Q4-21 GDP may be revised lower, and could be further disrupted by supply chain issues and continued labour shortages. Although, they also noted that the negative growth impact from the Covid-19 pandemic appears to wane with each new wave, as spending gets delayed rather than derailed. While the Omicron-wave is expected to dampen activity in the short term, it may also exacerbate medium-term inflation pressures. Combined with higher prices of core goods, soaring energy costs and elevated wage growth, the MPC believed an immediate hike in rates was necessary to contain inflation risks.

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This is the first change to the Bank Rate since the BoE slashed rates from 0.75% to 0.1% in March 2020 (**EXHIBIT 1B**), in response to the pandemic, and the first hike since August 2018. Nevertheless, interest rates remain at historically low levels with the mini-hike only restoring base rates to the prevailing level following the Brexit referendum in August 2016.

WHAT NEXT?

In retrospect, the BoE's latest rate hike represents a dramatic pivot from expectations of negative base rates as recently as the first quarter of 2021. With inflation now "more persistent" than expected, the hike could signal the start of a new interest rate cycle. Indeed, the MPC noted that some further "modest tightening of monetary policy" is likely to be required to meet its inflation target.

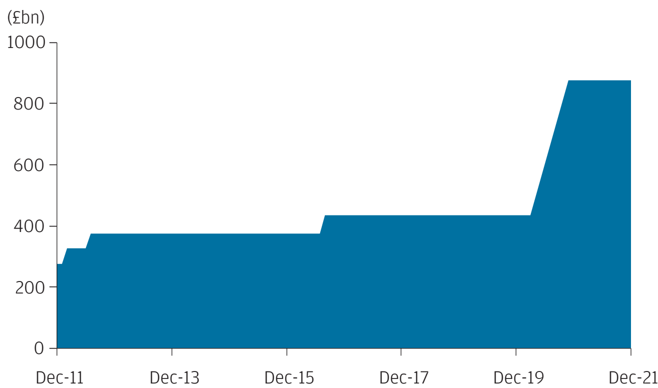
However risks remain balanced, the impact of the Omicron variant and the persistence of cost pressures will be the key determinant of future hikes and ultimately where the terminal rate will land. While forward SONIA curves imply additional rate hikes are likely (**EXHIBIT 2**), these same curves are pricing in rate cuts around 2024 as a reflection of uncertainty for long-term growth.

INVESTORS IMPLICATIONS

Sterling cash investors, grappling with low yields since March 2020, will welcome this small increase in base rates as a step towards higher returns. Improved time deposit rates and steeper curves should allow liquidity and ultra-short duration strategies to also boost returns - albeit with a slight delay due to the need to reinvest maturities.

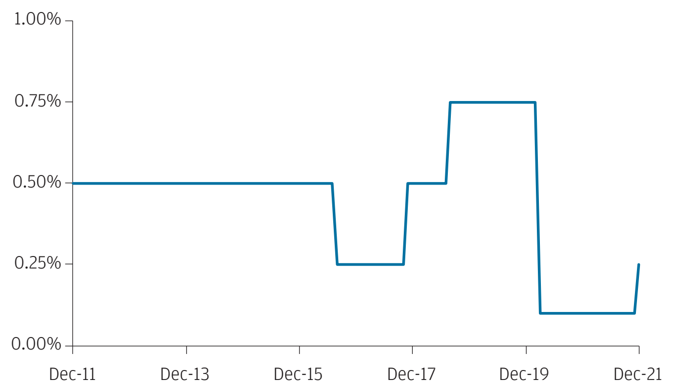
Meanwhile, the conflict between inflation and growth suggests bond yields and curve volatility could remain high (**EXHIBIT 3**). Nevertheless, given the increased risk of capital losses on longer duration strategies, sterling investors should consider adopting a disciplined approach to cash segmentation. By prioritising a combination of money market and ultra-short duration strategies, this should allow investors to optimise returns without excessively increasing risk or volatility.

EXHIBIT 1A: BOE PAUSED ITS ASSET PURCHASE PROGRAM



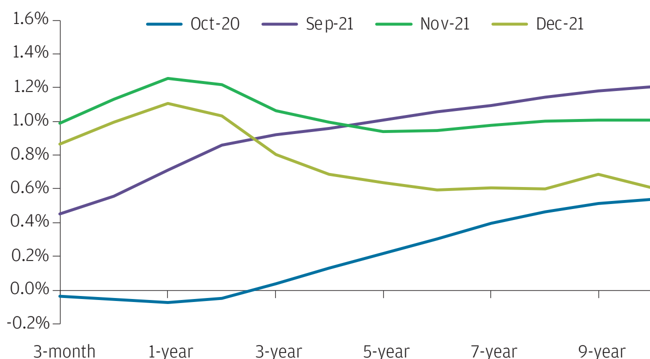
Source: Bank of England, as at 16 December 2021.

EXHIBIT 1B: UK BANK RATE REMAINS CLOSE TO HISTORICAL LOWS



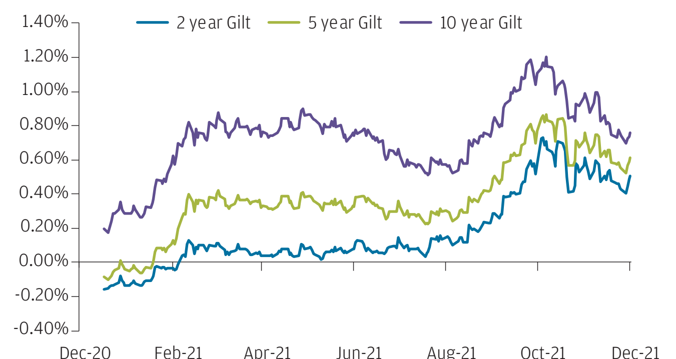
Source: Bank of England, as at 16 December 2021.

EXHIBIT 2: UK SONIA FORWARD CURVES ARE PRICING A LOWER TERMINAL RATE AND CUTS AROUND 2024



Source: Bloomberg, as at 16 December 2021.
Forecasts are not a reliable indicator of future performance. Past performance is not a reliable indicator of current and future results.

EXHIBIT 3: YIELDS ON LONG TENOR UK BONDS, REMAIN ELEVATED RELATIVE TO START OF YEAR LOWS



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