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BoE hikes by 50bps as expected but keeps options open for November

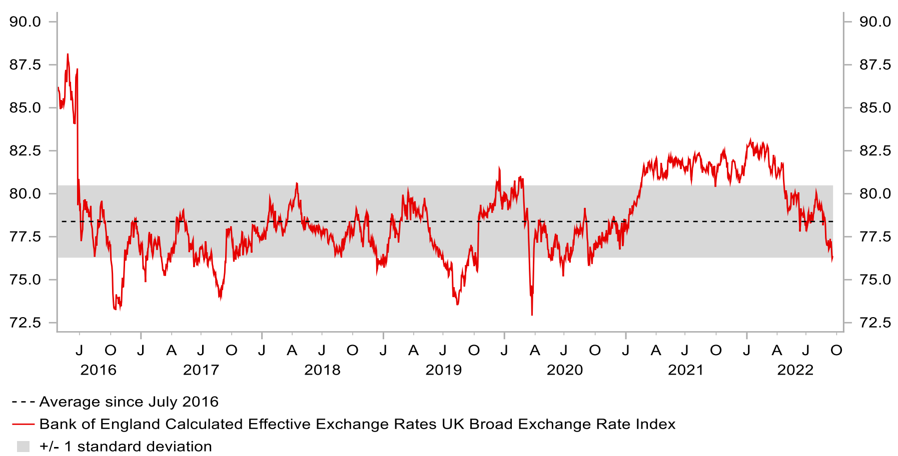
22nd September 2022

- *The MPC vote to hike by 50bps to 2.25% was split 5-3-1 underlining the continued divisions within the MPC*
- *The MPC made clear that the 'Growth Plan' to be announced tomorrow by Chancellor Kwarteng would be fully assessed as part of the run-up to the November MPC meeting when updated forecasts and projections will be published.*
- *In this current world of central banking, a 50bp hike is likely to be deemed cautious and points to continued downside risks for GBP.*

MPC keeps options open with opposing factors to consider

Given JPY intervention and warnings on both sides of CHF intervention by the SNB, we have already seen some wild swings in the FX markets today. The 50bp rate hike by the BoE therefore has paled somewhat into insignificance given the moves elsewhere. GBP is broadly stable on the back of the announcement while the rates curve has shifted higher by a little over 10bps despite the market being more closely priced for a 75bp hike. The factor supporting higher rates in the aftermath of the announcement is clearly the reference made to assessing the details of the UK government 'Growth Plan' as part of its updated forecasts in the Monetary Policy report for the next MPC meeting on 3rd November. That is a clear signal that based on those

BOE FOCUS COULD TURN TO BOE TWI PERFORMANCE



Source: Bloomberg, Macrobond & MUFG GMR details, the MPC could then be in apposition to hike at a faster pace if required. One notable update came in the lowering of the near-term inflation projection. The peak was estimated at 13.1% in August but the energy price cap now means this will be "just under 11%" instead. The BoE also now believes the economy is in recession. After a -0.1% Q/Q GDP print in Q2, the BoE estimates a contraction of -0.1% in Q3 compared to an original forecast of +0.4%. This reflected a smaller bounce-back in growth from the Q2 contraction (which was impacted by the Jubilee bank holiday) and the bank holiday due to the passing of Queen Elizabeth II. Still, ignoring the bank holiday effect, it is clear the economy remains very weak at this juncture. It helps explain the reluctance of the MPC to act more aggressively.

And then there were two

The 5-3-1 vote today included one vote for just a 25bp hike. When the vote hit the screens most would have assumed that would have been Silvana Tenreyro. But Tenreyro went with the majority for 50bps and in fact the sole dissenter for 25bps was Swati Dhingra the newest MPC member and her first vote. This is a notable development as it implies we have a new MPC member who is clearly on the dovish end of the MPC voting spectrum and could be a consistent challenger to Tenreyro's mantle as the most dovish MPC member.

Swati Dhingra replaced Michael Saunders who was the most consistent hawk and since November 2021 had voted for a higher policy rate than the agreed level in four of his last seven MPC meetings. It seems clear from this first vote that as a whole the MPC has turned more dovish.

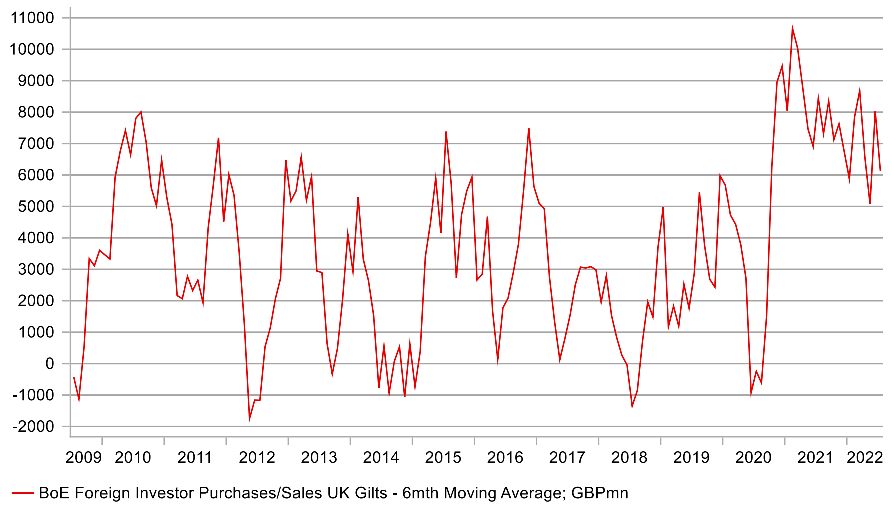
Balance sheet shrinkage to include outright Gilt sales

At the August MPC meeting, the BoE had laid out its plans for commencing outright sales of Gilts in order to speed up the process of balance sheet shrinkage. This in reality is required given the maturity profile of the Gilts purchased would have meant a very slow run down of Gilt holdings by merely not reinvesting maturing bonds. As was outlined in the August minutes, a reduction of GBP 80bn in the stock of Gilt holdings over a 12mth period would imply outright sales of Gilts of approximately GBP 10bn per quarter. While the fiscal outlook (see below) suggests downside risks to Gilt prices going forward, such a modest scale of outright sales is unlikely to be disruptive to market conditions. Outright Gilt sales will commence on 3rd October for short-dated Gilts, 6th October for medium-dated and 13th October for long-dated.

The "fiscal-event" up next

It was originally to be called a "fiscal event" as tomorrow's announcement will not be accompanied by an OBR assessment and updated forecasts. These "fiscal events" are therefore emergencies like during covid. But it seems bar the lack of an OBR assessment this is turning from a mini-budget into a not-so-mini-budget with PM Liz Truss indicating in an interview in New York on Tuesday that we could be about to witness a profound shift in economic policy. The government has already committed to GBP 37bn of support, has announced the energy price cap worth possibly GBP 150bn and will tomorrow confirm in the now named 'Growth Plan' the reversal of the NICs increase and the scrapping of the corporate tax increase from 19% to 25%. On top of that it is being report that an income tax cut could be announced and a cut to stamp duty along with tax incentives for investments regionally for corporations. When all of that is combined with the energy price cap for corporations for at least six months, we may be talking of a total figure in the region of GBP 200-250bn. Covid support totalled a little over GBP 300bn meaning in the space of a few years, we have had GBP 0.55 trillion of fiscal support – around 23% of GDP.

FOREIGN INVESTOR PURCHASES OF GILTS SLOWING (6MTH MAV)



Source: Macrobond & Bloomberg

FX implications

As is always the case, there are cross-currents in the FX markets today that are playing a role in GBP performance. The intervention to sell US dollars by the MoF in Japan is an important development that is likely providing support for the pound. With USD/JPY down 2.25% as we write, it has taken some of the positive momentum away from the US dollar. We are sceptical of the sustainability of that impact given the fundamental backdrop for JPY buying does not exist.

Separate to that the UK rates curve is also higher which is perhaps the surprise given the market was partially priced for 75bps today. The reference in the statement and the minutes to the full assessment of the 'Growth Plan' to be unveiled tomorrow is crucial in explaining that and this too is likely providing some support for the pound.

We have been highlighting downside risks for the pound based on possible fiscal details tomorrow that lack credibility and raise concerns over external financing pressures given the budget and current account deficit combined looks to be heading to around 15% of GDP. The issue tomorrow though is the lack of OBR assessment and hence we cannot rule out a scenario of some period of GBP outperformance if investor choose to focus on positive growth consequences. How credible plans are for breaking the link between natural gas prices and electricity prices will be important.

But if there is any outperformance tomorrow, we remain sceptical of that being sustained. It is hard to envisage GBP resilience in the face of external financing requirements when central banks are actively engineering much tighter financial conditions to drive inflation expectations lower. That points to further GBP/USD downside once we have had this Tokyo intervention driven shake-out of long USD positions over the short-term.

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