Market Update: 6th August 2020

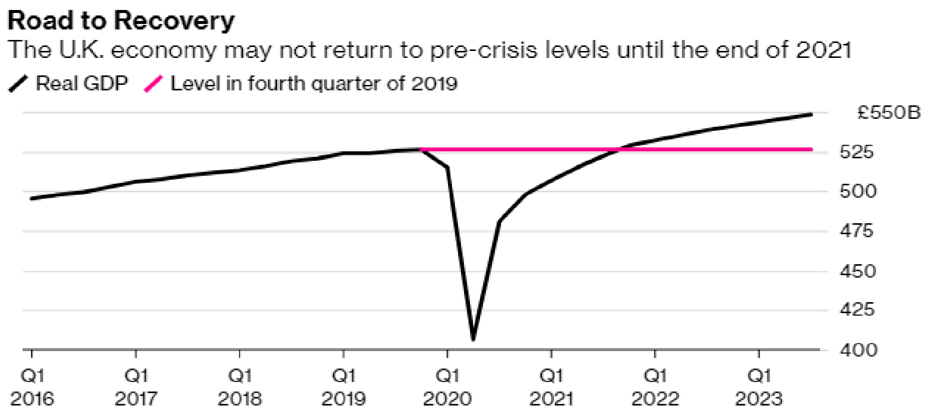
The Bank of England Holds Off on Further Stimulus

The Bank of England's Monetary Policy Committee (MPC) affirmed its current policy today as it voted unanimously to keep interest rates and asset purchases unchanged at its August meeting. In a press conference this afternoon on the conclusion of the two-day MPC meeting, Bank Governor Andrew Bailey released more robust projections on the UK economy and reiterated the central bank's commitment to support the UK economy through its long road to recovery.

In recent weeks, the case for further monetary stimulus has been growing stronger as a nascent rebound from the pandemic-induced recession risks fading as virus concerns remain high. While no further stimulus was expected at this month's meeting, expectations have been increasing among economists that the bank will need to go further to help stimulate the economy after the summer.

During the height of the pandemic, the Bank of England stopped providing formal projections due to a lack of official data, however updated its scenario based forecast this month as the evidence of a recovery and further indications on the pace of the recovery have now become more apparent in the economic data. Although the bank issued more positive expectations than first anticipated in its forecasts (with a smaller spike in unemployment and lower decline in annual GDP than expected back in May), the more upbeat forecasts did little to temper expectations that another round of bond purchases will be required before the end of the year amid renewed lockdowns in parts of the country and as the government's job support program draws to a close.

Consistent with the government's stated policy aims, the BoE's latest forecasts do not include a second nationwide lockdown, but do assume a slow recovery with the possibility of more restrictions. As a result, the bank stressed that the economy is unlikely to fully recover before the end of 2021, as shown in the chart below.



Source: Bank of England
Note: Figures based on market interest rate expectations, include backcast

Stimulating the Recovery

After a challenging first half of the year, data now suggests that the UK's recovery is underway, with output from the dominant UK services industry increasing at the fastest rate since 2015 in July as more of the economy opens up post-coronavirus lockdown. IHS Markit's Purchasing Managers' Index rose to 56.5 last month, up from 47.1 in June. This is well above the 50 level that indicates expansion for the first time in five months. At the same time, manufacturing also climbed higher to 53.3 in July, up from 50.1 in June. The data sounds an optimistic note about the UK economy; however employment will remain a key concern for policymakers over the coming months.

So far, Chancellor of the Exchequer Rishi Sunak has spent more than £40 billion helping more than 12 million workers since the crisis began - an intervention that has helped to keep the unemployment rate low. However, as government support for the labour market winds down as we approach the October program end date, the outlook for unemployment is becoming a particular concern and a major risk for the Monetary Policy Committee moving forward. The updated economic projections provided more indication of the BoE's view of the shape of the recovery, which is now thought to be more gradual than it first anticipated, while the recession is less severe than first anticipated.

Interest rate and Inflation Expectations

With borrowing costs so close to zero at a current rate of 0.1%, investors will be closely watching for any updates on the BoE's review on the viability of negative rates in the coming months, with the bank's review of the effectiveness of negative rates still ongoing. Bailey did mention that effectiveness could be hampered by the damage that the crisis has wrought on bank balance sheets at this stage, however held back on ruling out the option.

- **Why Negative Rates?**
  The theory behind negative rates is that commercial banks will be charged to lodge their money with the bank, with those charges then having to be passed on to their customers. This would encourage banks to lend, and prompt firms and households to spend rather than save, thus giving a lift to the economy.

  The prospect of negative rates in the UK was ruled out by the previous BoE Governor Mark Carney, but the idea has regained prominence since the Covid-19 pandemic struck the British economy and prompted further rate cuts this year. The ongoing damage to activity, the prospect of further job cuts and a potential second wave of the virus further down the line alongside a disruptive break from the EU have spurred policymakers to announce that they are reviewing all available stimulus tools.

In terms of inflation, in the short-term inflation is expected to fall further below the target and average around 0.25% before recovering in the medium term (in 2-4 years' time). Policymakers also expect unemployment to rise to around 7.5% by the end of the year, with most officials agreeing that the labour market will be the key to the recovery and getting long term monetary goals back on track sooner. Policymakers have reiterated that they do not intend to tighten monetary policy until there is clear evidence that the economy is recovering and inflation is near the 2% target sustainably, indicating that rates will remain extremely low for the foreseeable future.

Market Expectations

While the period since the MPC last met in mid-June has seen growing evidence of an economic recovery, aided by the steady relaxation of coronavirus related restrictions, the tone of the comments by MPC members has been heavy on emphasising the risks to the outlook. If these risks materialise, members who have expressed concerns in recent weeks could form a nucleus of support for more monetary policy action further down the line.

Some market participants (driven by Bank of America) see the Bank of England announcing an aggressive package of interest-rate cuts and quantitative easing in November to stimulate an economy in recovery from the pandemic and the threat of a no-deal Brexit. According to Bloomberg, money markets have started to price in a cut to negative rates in September 2021. The government is expected to issue further stimulus in its Autumn budget later this year, therefore any central bank action taken towards the end of the year would likely be part of a combined approach.

It is our view that any further stimulus is likely to be weighted towards the end of the year into 2021 as the employment picture becomes clearer, and will likely come alongside fiscal stimulus, however we do not expect to see negative rates this year. The near-term outlook remains uncertain with continued virus risks, and we expect to see further volatility in the second half of the year as the UK economy recovers from the pandemic-induced recession. What is clear is that the BoE remains poised to act should we see some more persistent signs of weakness, which will continue to provide support to markets in the short term.