Bank of England: Expect renewed caution as chances of November stimulus grow

With November action from the Bank of England looking ever-more-likely, we'll be watching closely to see if policymakers offer up any further clues on which tools they're most likely to use. The message of recent weeks suggests QE remains the preferred tool, although negative rates can't be ruled out either over the coming months

The list of economic challenges is growing

The list of challenges facing the Bank of England (and the Treasury) is growing.

Brexit is back with a bang, and there's a growing risk that the transition period will end with no trade agreement in place between the UK and the EU. With-or-without a deal, there will be new costs for businesses, and that will affect some sectors that have so far been less-impacted by the pandemic (agriculture is a good example).

But without a trade agreement in place, there's unlikely to be many measures to mitigate the potential disruption at the ports, and the overall impact is likely to drag on the UK's post-Covid recovery.

Unemployment is likely to grow through the autumn, and potentially more than the central bank's forecasts back in August, which was at 7.5%

One consequence is that it could add further downside to the jobs market. Unemployment is likely to grow through the autumn, and potentially more than the central bank's forecasts back in August (7.5%). Exactly where the jobless rate peaks will in large part depend on whether the Treasury adds targeted support to industries that are still unable to open due to Covid-19.

The implication is that the economy is likely to take longer to recover than the Bank had previously anticipated. We think it may not be until late-2022 or beyond until all of the lost output has been regained. The BoE's August forecasts assume this would happen by the end of 2021.

Two things to expect this week

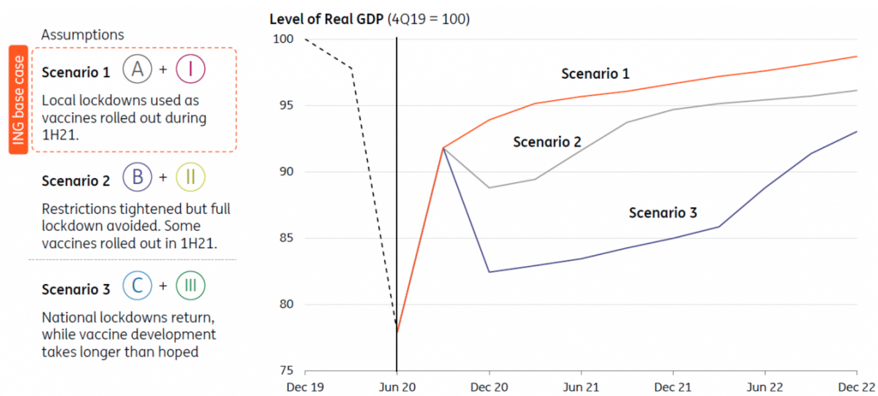
While it's unlikely the Bank will rock the boat too much this week, there are two interesting questions.

Firstly, will policymakers acknowledge that the downside risks to their August forecasts are growing? Certainly, some MPC members have been sounding more cautious in recent weeks.

And if so, secondly, will the Bank offer any clues as to how it might increase the level of stimulus in November? Despite the recent hype surrounding negative rates, Governor Andrew Bailey has indicated that he believes quantitive easing (QE) is a more useful marginal policy tool, and this is likely to be at the centre of the stimulus package we expect in the autumn.

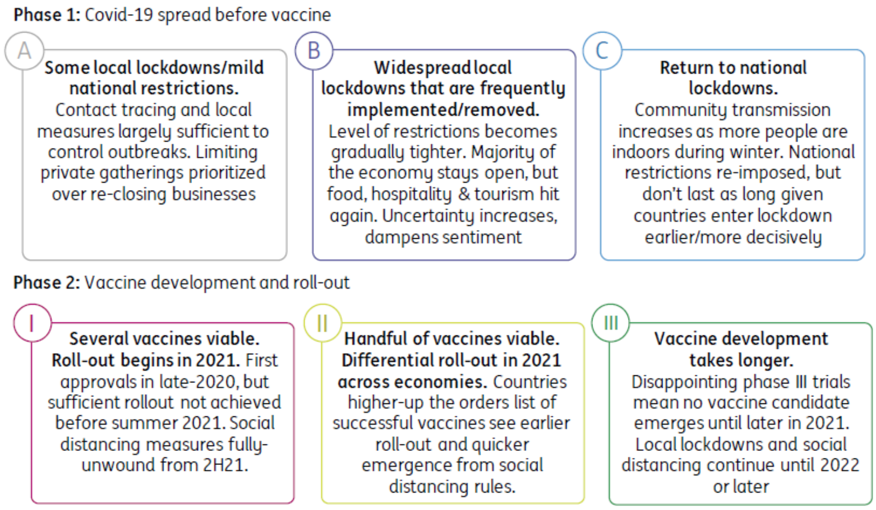
On interest rates, there was a lot of discussion about the pros and cons of negative rates in the last monetary policy report, but the Bank is clearly still on the fence about how useful they might prove to be. In the first instance, we suspect policymakers will look to lower the interest rate on the Term-Funding Scheme, which incentivises lending to SMEs. However full-blown negative rates are also a clear possibility over coming months, particularly if the economic outlook were to worsen materially.

Three ING scenarios for the UK economy



Source: ING

ING's new scenarios explained



Source: ING

Rates reaction: Brexit noise and higher QE probability

The near-term outlook for gilt yields is more likely to be driven by any Brexit-related flight to quality flow than central bank action. This is because with about one and a half month before the all-important November meeting, odds of leaving the EU without a trade deal in place have time to swing about quite significantly. Nevertheless, Thursday's meeting will be key in shaping expectations of further easing in November, and what form it would take.

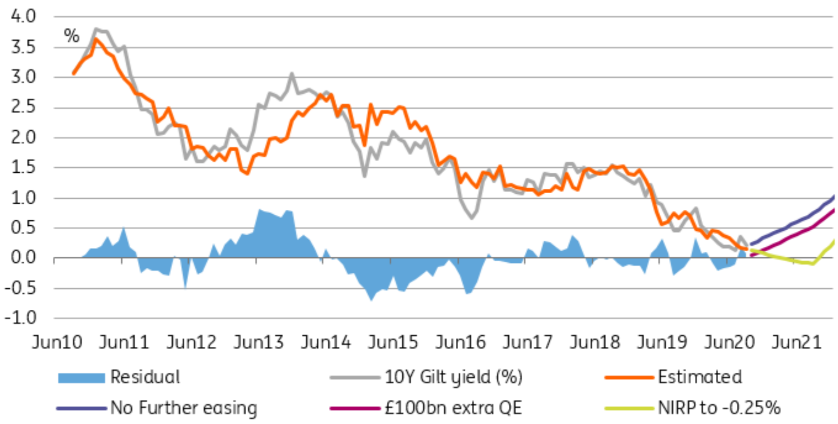
> *Our long-term monetary gilt model highlights that the highest probability-scenario is also the least impactful*

We think the market consensus is quickly converging towards answering the first question, whether to add easing in November, in the affirmative. This is not to say a dovish rates reaction to the BOE is impossible, but the bar is high, and it will largely depend on the MPC's easing preference.

Inputting two different scenarios to our long-term monetary gilt model highlights that the highest probability-scenario is also the least impactful.

In light of recent MPC communication, markets have shifted back to QE being the most likely easing tool in the near future. This explains in part why an additional £100bn of QE would only shift 10-year gilt 'monetary FV' lower by 20p by the end of 2021. More importantly, perhaps, this outcome on its own would not amount to a change in dynamic for GBP rates, with the floor holding firm around 0%.

Gilt yields have much more downside if the BOE goes negative than if it adds to QE



Source: Bloomberg, ING

Negative interest rates: A low-probability, high impact scenario

A negative interest rates policy (NIRP) on the other hand would have far-reaching implications.

The first-order effect of a cut to -0.25% would be to remove the 0% floor under gilt yields due to a commensurate drop in repo rates. In this scenario, the impact would be 10-year gilt yields dipping below 0% for much of 2021. More importantly, the removal of the 0% floor means markets would feel justified in pricing a non-zero probability of rates dropping further and would push further away from the date of the first expected hike.

In that respect, our NIRP scenario above would probably be a first step towards a more significant downward shift in GBP curves.

In short, the debate on further monetary easing is adding downward risk to a very shallow recovery in GBP interest rates.

If recent communication is any guide, the central bank will signal that QE remains the marginal tool of choice which should translate into a small downward move in gilt yields, likely to be drowned out by day-to-day Brexit noise. A preference for negative interest rates, though less likely, would require a much sharper drop in rates, not least because it would leave investors guessing the ultimate floor under the Bank of England's bank rate.

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