Bank of England: Three things to expect from May's meeting

An improving economic outlook means the Bank of England will make some upgrades to forecasts and may also begin tapering its asset purchases at this next meeting. There are already hints that gilt markets are beginning to adjust to less central bank buying over coming months

Bank Of England, London

Source: Shutterstock

1 An improving outlook means upgraded forecasts

As the UK economy begins to emerge from the pandemic, we'd expect a cautiously optimistic tone from the Bank of England at its meeting on 6 May.

Indeed, the BoE's outlook has already been arguably more optimistic than most forecasters. Back in February, policymakers projected that the size of the UK economy would return to its pre-virus size around the turn of the year. While we think that may still prove to be a tad optimistic, there's little doubt the newsflow over recent weeks has helped that view.

For instance, the hit to GDP through the first quarter from lockdowns and the new EU trade deal has been much more modest than first thought. We expect the BoE to revise up its expectations for 1Q from -4.2% to roughly -1.5% (QoQ).

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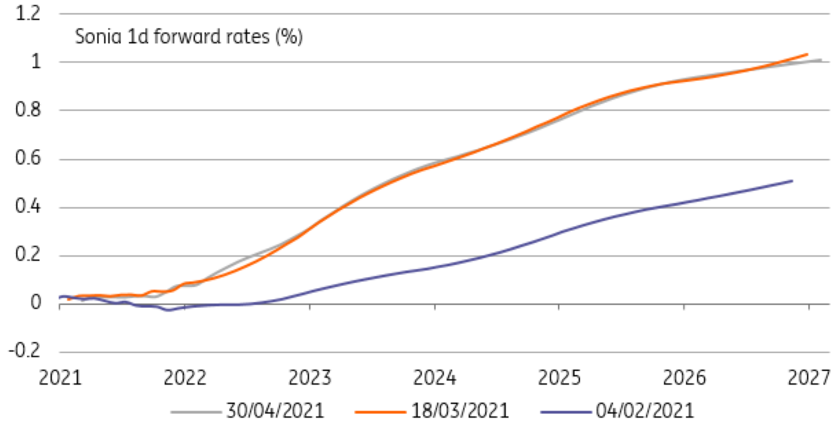
More importantly, the reopening plan potentially also means a sharper 2Q uplift than the Bank had previously been pencilling in. Meanwhile, rather quirkily, the inclusion of Covid-19 testing and vaccines into the GDP figures has artificially lifted the level of activity quite noticeably.

Another potential upgrade comes from the jobs market. The Bank previously expected the unemployment rate to peak close to 8% in the middle of the year, a big jump from the current 5% level, linked to redundancies as wage support is removed.

While it remains considerably uncertain, we suspect this is an overestimate. The fact that the Job Retention Scheme has been extended until September should enable most businesses to rebuild their finances sufficiently to be able to bring back most of their furloughed staff. We could see the peak revised down to more like 6.5%, and we think there's a fair chance the jobless rate will be falling again by year-end.

We also suspect we could see an upward tweak to the 2021 inflation profile, taking headline CPI above target. The question is whether it stays around 2% – and the Bank's forecasts from February suggested it expected the answer to be largely yes. In our view though it's more likely to drift back below target through 2022.

Sonia swaps are pricing an early but shallow tightening path



Source: Refinitiv, ING

2 Time for tapering?

That more upbeat outlook means further stimulus now looks unlikely. And in fact, we think this meeting could be the moment where the committee decides to taper the pace of its bond purchases.

Admittedly this should come as no real surprise. We know the Bank of England still has circa £110bn worth of gilt purchases to make this year when you wrap in redemptions. And at the current £4.4bn weekly pace, the BoE will hit its target level of £875bn (gilts) months before the end of the year, when it has signalled it will stop actively expanding holdings. It has already explicitly said tapering is likely.

We expect tightening to begin in 2023

What could this involve? A cut in the weekly buying pace to roughly £3bn/week from now onwards would allow the Bank to reach its target around the end of the year. The alternative option is to continue at the current, more rapid pace until the June meeting, though clearly this would require a steeper cut in pace. This would probably involve taking the weekly speed below £2.5bn/week, which would be lower than the pace generally employed in past QE episodes.

What about the longer-term tightening story? We doubt we'll get much in the way of clues this time, not least because markets have gone from pricing in zero hikes at the February meeting, to two over three years in April.

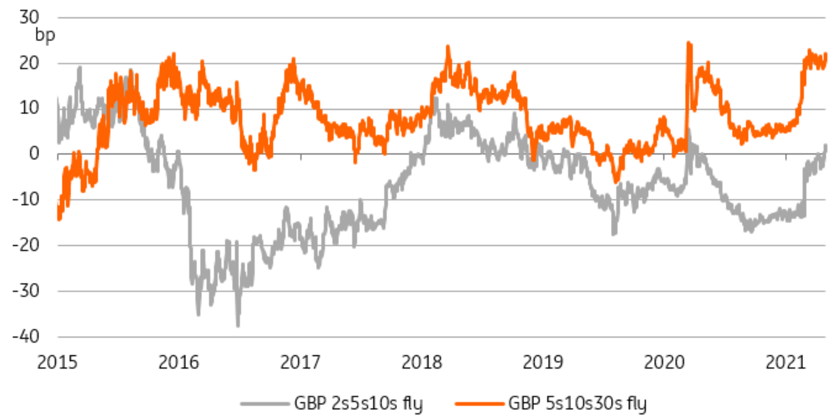
We expect tightening to begin in 2023, but there's still an open question on what mix of interest rate hikes and balance sheet reduction this will involve. It's become clear under Governor Andrew Bailey that the latter will be a part of the process. We'll have a piece out in the coming days looking at how this might work and what the impact may be. The BoE has already said it is reviewing its guidance on the future of its balance sheet, so the message is to stay tuned.

We may also hear a bit more this week on the Bank's new green mandate. As part of its new objective to support the net-zero transition, the BoE has indicated it will make changes to its corporate bond scheme when the next round of reinvestments comes due later in the year. According to our Sector Team, the most obvious way of 'greening' the scheme would be to gradually target a greater proportion of reinvestments towards high-ESG scoring issuers. Our March BoE preview looked at some of the potential challenges associated with this approach.

3 Gilts bracing for a taper

Encouraging economic developments are also visible in the performance of UK gilts. Their recent tightening relative to US Treasuries is a clear sign to us that the government bond market is bracing for lower central bank support in the coming months. The GBP rate market has also taken a resolutely European feel, refusing to retrace its 1Q sell off, and even making further headway towards normalisation. We find it entirely possible that the next leg up in traded GBP rates will be driven by a delayed 'reflation trade' in Europe, although upside risk is also building in the US.

The GBP curve is showing that BoE tightening is getting nearer



Source: Refinitiv, ING

Curve dynamics are also suggesting that the gilt market will soon have to fly on its own. The sharp cheapening of the 10Y sector of the curve, for instance in the GBP swap 5s10s30s butterfly, is indicative of a build-up in term premia. This is what one would expect to occur when normal price discovery is no longer influenced by central bank purchases.

> *There is a risk that sterling rate markets jump the gun and price in a hiking cycle too early*

Using a similar type of analysis, the fact that GBP 2s5s10s has so far failed to adjust higher is also a symptom of the uncertainty about the BoE's tightening strategy. The fact that balance sheet reduction could occur earlier in the cycle has kept the curve relatively steep. We think this is correct, but there is a risk that sterling rate markets jump the gun and price in a hiking cycle too early. If the BoE only clarifies its exit strategy later this year, cheapening pressure would build up for the 5Y sector.

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