

Bank of England: Three things to look for this Thursday

We don't expect the Bank of England to add fresh stimulus this week, although the pressure to beef-up its QE programme will build over the next few months, not least because the economic recovery will be very gradual. We think policymakers will push back on the idea of a 'V-shaped' recovery when it unveils new forecasts on Thursday



Source: Shutterstock

Focus on forecasts as Bank of England takes stock

It's been a busy few weeks for new Bank of England Governor Andrew Bailey, who will oversee only his second scheduled meeting and his first quarterly Monetary Policy Report this week. Like other major central banks, the BoE hasn't held back from acting between meetings. And with financial markets returning to a relative state of calm after the March madness, this week's meeting will be an opportunity to take stock. We don't expect any major new policy announcements this time.

Still, there will be plenty to digest when the Bank releases its decision at the earlier time of 7:00BST on Thursday. Here are three things we will be focusing on...

1 Forecasts - expect policymakers to pushback on idea of 'V-shape' recovery

The Bank of England's new forecasts could follow a similar blueprint to the European Central Bank, which last week laid out three scenarios based on different speeds of reopening/recovery. That means the Bank doesn't need to make a formal assumption about the reopening process, something the UK government is set to unveil later this week.

Our own forecasts published back in April assumed around a 10-15% peak-to-trough fall in output (when measured on a quarterly basis), although we wouldn't be surprised to see the Bank of England pencil in a sharper decline. In the end, the precise size of the fall is a little academic now - more relevant is the speed and shape of the recovery.

We expect this process to be fairly gradual, not least because some firms will not emerge from the crisis in the same shape, despite the government's best efforts. That, in turn, means unemployment could stay reasonably elevated for a prolonged period of time.

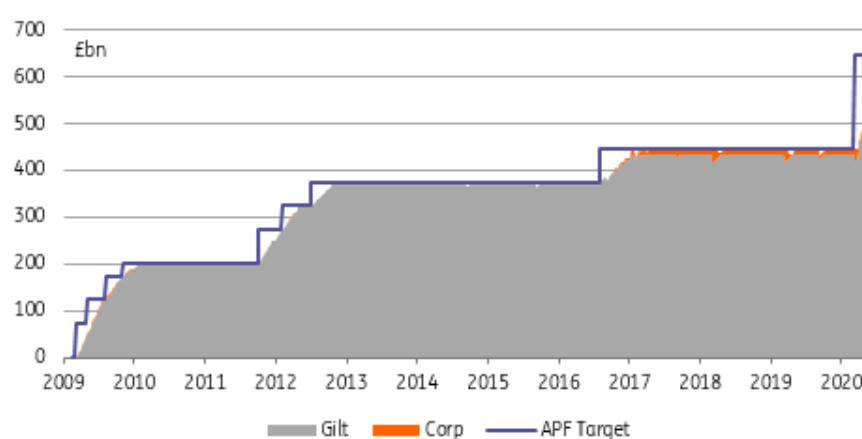
We'd expect the Bank of England to also push back on the idea of a 'V-shaped' recovery this week.

2 Quantitative easing: no extension for now...

The BoE's £200 billion QE package was larger than expected when it was announced back in March, and for the time being, gives policymakers plenty of scope to keep expanding the balance sheet.

From a flow point of view, there is no rush to expand the size of the QE target this week. For one thing, purchases remain well below the £645bn QE ceiling the BoE has set itself: the size of the QE portfolios have reached £514bn in total last week, of which just under £12bn is in corporate bonds. Extrapolating the current pace of purchases, we estimate the BoE has just under two more months to go before reaching the ceiling, more if it tapers purchases.

QE ceiling: there is still time



Source: BOE, ING

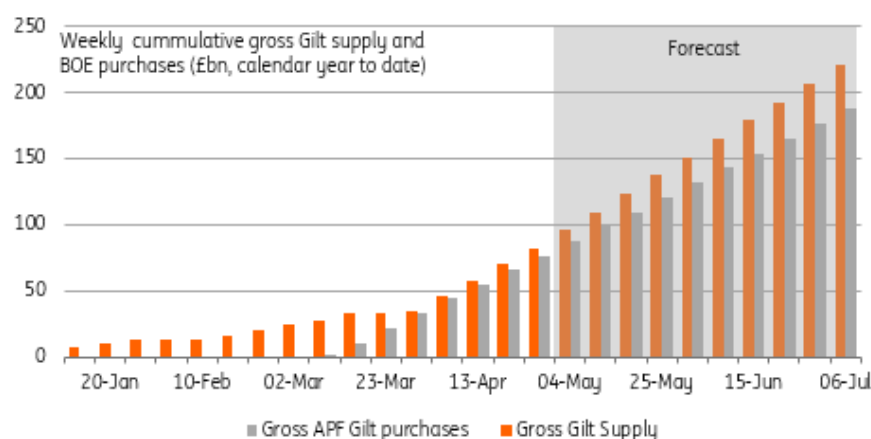
Another argument for upping the target would be to absorb additional Gilt issuance. So far this calendar year, the Debt Management Office (DMO) has sold £81bn of Gilts (before redemptions). For comparison, BoE purchases started only in March but have since removed £77bn of paper from

the market, most of what has been issued in 2020.

...but a decision needed by July

This balance is about to change in the coming months. [The DMO has announced it will sell 180bn of Gilt in the three months to July](#). This is a step change from previous borrowing plans that foresaw £156bn for the whole 2020-21 fiscal year. At the current pace, we estimate Gilt supply will exceed BoE purchases by a mere £7bn in the two coming months. After that, the only way to avoid a 'cliff-edge effect' is to expand the current programme, or at least to phase it out.

QE has absorbed most Gilts issued this year



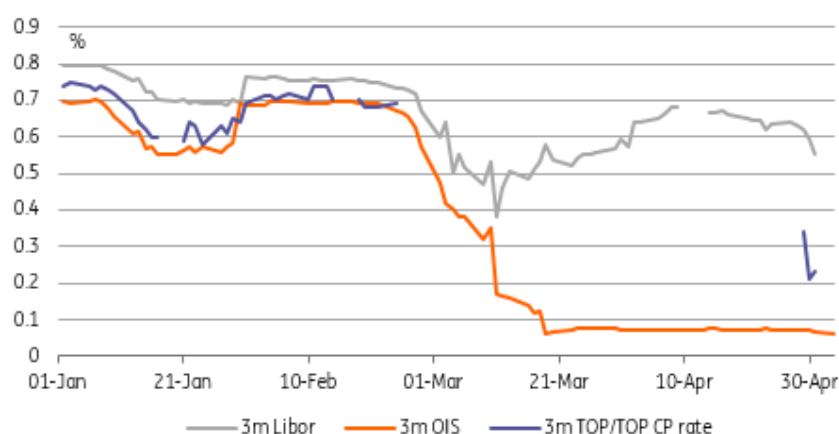
Source: DMO, BOE, ING

Tentative improvements in money markets

Our view that this meeting will be used by the BoE to 'take stock' of the effect of the measures announced so far is reinforced by the improvement in money market conditions. We are far from sounding the all clear but some indicators suggest a normalisation. For instance, Libor-OIS spreads have tightened back suggesting an easing of systemic risk in the banking system.

Granted, the same phenomenon has been observed in other jurisdictions but we note some anecdotal evidence of improvements in sterling money markets specifically. For instance, the Top/Top index of Commercial Paper rates indicates a cheapening of borrowing cost for high-rated companies and banks, after over two months of not publishing due to a lack of underlying transactions.

Indicators of financial stress have eased



Source: Bloomberg, ING

3 All credit to the Commercial Paper purchases

This brings us to the third item on the list. The BoE's commercial paper purchasing scheme (or CCFF as it is formally known) is perhaps a lesser-known, but arguably one of the most important, parts of the Bank's Covid-19 war chest.

It was designed at a time where the CP market was perceived to have dried up amid the global rush for cash. Like the Federal Reserve's similar scheme, the BoE aimed to return this key source of funding for corporates - and in turn reduce pressure on the Banks to provide funding through revolving credit facilities.

Tentative signs of improvement in money markets are a credit to the CCFF. [We noted at the time of its launch](#) that the mandated buying levels were aggressive enough to trigger a re-tightening to OIS. And the BoE seems to be putting in the work. Last week, it reported £15.9bn of CP holdings, with a £5.0bn increase from a few days earlier. This is also a step up from the previous programme launched in 2009 that saw its holdings of CP peak at £2.3bn.

There are other reasons to be optimistic: fiscal and monetary authorities are pushing in the same direction. The latest quarterly DMO issuance programme included no plan to increase the amount of T-bills in circulation. In our view, this removes a key risk for the sterling money market: that of government issuance crowding out private issuers.

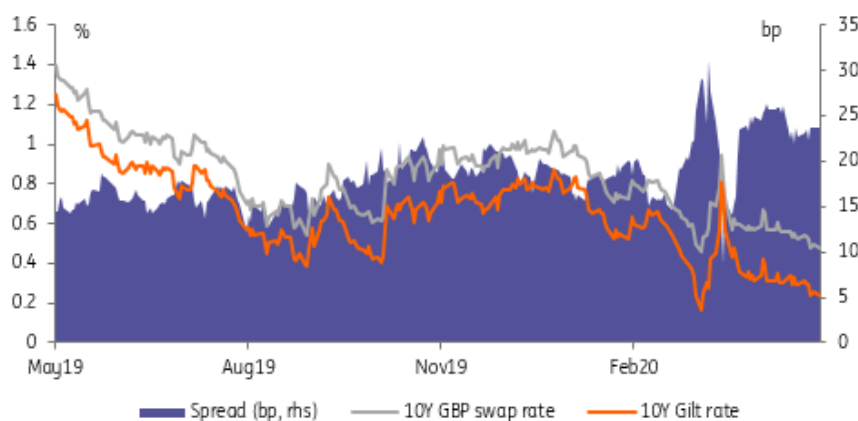
Market reaction: tactical re-steepening

The tight the Gilt supply/demand balance outlined above doesn't leave much scope for a structural increase in interest rates. Neither do dim economic prospects and uncertainty about the ability to fully reopen the economy. The easing of systemic risks thanks to BoE and government intervention could trigger a re-pricing of the risk premia embedded in Gilt valuations in our opinion. This is more likely to impact Gilt yields than swap rates but both are liable to a tactical increase of 5-10bp after the meeting.

The macro theme in sterling rates markets should remain the same however. Heavy central bank intervention, provided QE is extended, should continue to suppress rates and rates volatility. We think this is conducive to carry-seeking behaviour and should thus benefit the

5-10Y part of the curve, whilst opening the door to a progressive re-steepening of the long-end.

Rates have nowhere to go but risk premia should decrease



Source: Bloomberg, ING

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