Cautiously optimistic Bank of England catches markets off-guard

The Bank of England opted against cutting interest rates this month, instead choosing to wait-and-see how the recent rise in optimism translates into economic activity. A multitude of Brexit-related unknowns means a rate cut further down the line can't be totally ruled out, but for now we think rates are likely to remain on hold for the rest of 2020

What was all the fuss about?

After all the hype over recent weeks, the Bank of England has opted against cutting interest rates at its latest meeting. The key question now for markets is whether this meeting closes the door to a rate cut at future meetings.

Looking at the vote split, many investors may be questioning what all the fuss was about over the past few weeks. While two MPC members again voted for an immediate rate cut, the other two 'external' voters that had been mulling easing – Silvana Tenreyro and Jan Vlieghe - opted to keep rates on hold this time.

Interestingly, the Bank has also removed the long-standing guidance that future rate hikes would be “limited and gradual”. While the debate over tightening is clearly some way off, this may nevertheless be taken as mildly hawkish by some in the market.

Policy easing can't be fully ruled out

Having said all of that, the lingering question of policy easing is unlikely to go away just yet. It all really hinges on whether the economy sees a Brexit bounce. If you look at the sentiment data, the answer appears to be tentative ‘yes’. From the PMIs to the Bank’s own surveys, optimism has reportedly increased and activity is showing signs of moving up a gear after December’s election.

And this appears to have been a key factor behind the BoE’s decision to keep rates on hold this month.

However, there are good reasons to be sceptical about the potential for a sharp turnaround in economic activity. Firstly, the sentiment data has given false indications at political turning points in the past – most notably after the Brexit referendum in 2016.

Secondly, and more importantly, there’s a risk that business optimism starts falling again as the reality of UK-EU trade negotiations hits. With an extension to the post-Brexit transition period looking unlikely, negotiations will have to move fast to generate a bare-bones free-trade agreement this year.

Even then, this will involve big changes to the way goods and services providers trade with Europe from the start of 2020. While there’s plenty of uncertainty over how companies will react to these changes upfront, it’s unlikely to spur a wave of longer-term investment.

Rates likely to remain on hold in 2020

The upshot is that policy easing can’t be totally ruled out in 2020, and policymakers noted they’ll be “closely” monitoring the data over the next few weeks and months to see whether the rising optimism can be sustained, and whether it translates into a sharper pace of growth.

But the fact that no further MPC members moved over to the rate cut camp this month suggests that for the time being, the Bank of England is more likely to keep rates where they are at coming meetings.

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