GBP: Don't get excited about a hawkish BoE just yet...

Conflicting messages from BoE officials this week have left markets in a state of confusion when it comes to factoring in what UK monetary policy means for the pound.

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The bottom line is that nothing has changed and even under the most hawkish of scenarios – that the post-Brexit 25bp rate cut is reversed later this year – a very shallow Bank Rate path means that a sustained period of GBP appreciation is unlikely. Our expectation for a slowdown in the UK economy should make the case for rate hike less compelling; this slightly more bearish view means that our base case remains for GBP/USD to fall to 1.24 and EUR/GBP to move up towards 0.90.

The BoE's "cacophony problem" = GBP volatility

It's clear that the June policy meeting – and speeches by key officials this week – have highlighted the degree of independence at the BoE. An MPC with diverse views is not necessarily a bad thing –

and central bank transparency should not be knocked back. But there is an optimal level of transparency. The purpose of central bank communications is to make monetary policy more predictable, although pushing the boundaries could lead to what former Federal Reserve Vice-Chair Alan Blinder once described as a “cacophony problem” – where an MPC that speaks with a range of views could ultimately end up having “no voice at all”. The recent mixed messages from the BoE risks having this effect, with greater policy uncertainty ultimately increasing (not decreasing) volatility in rate-sensitive UK asset prices.

Hawkish BoE talk has at best put a floor under GBP for now

We prefer to look through the recent “noise” coming out of the Bank. Bar any knee-jerk GBP moves that will arise from further mixed signals, we think at best the current neutral-hawkish BoE sentiment will put a floor under GBP/USD around 1.2550 and limit EUR/GBP upside to 0.8850. Equally BoE-induced GBP upside looks limited given that markets are already pricing in a 45% chance of a Bank rate hike by end-2017.

It’s worth noting that a 2017 rate hike is not our central scenario and we still think the near-term risks to GBP lie to the downside – especially as our expectation for a slowdown in the UK economy makes the case for rate hike less compelling. This slightly more bearish outlook means that our base case is still for GBP/USD to fall to 1.24 and EUR/GBP to move up towards 0.90.

1.24 Our base case is still for GBP/USD to move lower on political uncertainty and weak UK data

BoE policy a trivial factor until short-term political woes dissipate

Our own analysis tends to corroborate that of the BoE’s and shows that since 2016, we have witnessed a sharp decline in the sensitivity of UK yields to economic data surprises (see LHS chart below). However, one has to view this in the context of what has been driving UK asset prices. Arguably, there’s a Brexit-factor involved here; markets are less concerned with the current economic paradigm, but instead making some form a judgement on the future long-run state of the economy in a post-Brexit world. This is certainly true for the pound – which we have previously noted is around 15% undervalued against the dollar and the euro.

Add to this the recent uptick in UK political uncertainty, and it’s clear that BoE policy is a trivial factor for GBP markets at present. While GBP/USD does remain most sensitive to short-term interest rate differentials (see RHS chart below), our financial fair value model for GBP/USD points to a 3% risk premium priced in at present. We attribute this to current state of politics in the UK and questions over the stability of a minority Conservative government.

Click here to see BoE Chief Economist Andy Haldane's speech

And what if the BoE does hike rates in 2H17…?

UK economic data – in particular wage inflation – would need to surprise to the upside, while short-term political uncertainty would probably have to ease from current levels. Still, we argue that even under the most hawkish of scenarios – that the post-Brexit 25bp rate cut is reversed later this year – a very shallow Bank Rate path means that the impact of a BoE rate hike on GBP should be fairly negligible. GBP/USD could unwind some of its political risk premium and move up towards 1.30, while EUR/GBP could equally fall back towards the 0.85-0.86 range.

But a sustained period of GBP appreciation – and the start of a new wave of bullish momentum – seems unlikely from any small policy adjustment. Ultimately, we think the BoE's medium-term policy rate path remains a function of Brexit more than anything else; this is the certainly view that Governor Carney adopted in his Mansion House speech earlier this week and a cautious 2H17 rate hike is unlikely to be a GBP game-changer.