

## Bank of England takes cautiously optimistic stance despite rising yields

Like the Fed, the Bank of England has signalled it remains relaxed about the recent rise in gilt yields and rate hike expectations. That tells us we're unlikely to get negative rates in 2021 and instead there will be a growing focus on tightening, though this process is unlikely to start before 2023



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### The Bank of England channels the Fed

The key takeaway from the latest Bank of England meeting is that it's not unduly fazed by either the rise in bond yields or the noticeable increase in rate hike expectations that have occurred over recent weeks. Investors are now pricing roughly two rate hikes over three years.

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*The governor's statement tells us the Bank is much more closely aligned with the Fed's attitude to recent market moves than the ECB's*

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The statement echoes recent comments from governor Andrew Bailey that the rise in yields reflects optimism, while financial conditions are 'broadly unchanged'. That tells us the Bank is much more closely aligned with the Federal Reserve's attitude to recent market moves than the ECB's. And that's particularly noticeable if you look at the Bank's plans for its quantitative easing programme - policymakers have opted to keep the pace of gilt purchases largely unchanged in the near-term, ahead of a potential slowdown later this year.

## Negative rates unlikely, though tightening unlikely before 2023

Based on the outlook as it stands, it's hard to see the Bank seriously deviating from this approach for at least the next few months.

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*Negative rates remain unlikely this year, barring a serious setback in the recovery process*

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Despite the unexpected setback in vaccine supply for April, there is a sense that the pace should re-accelerate in May and enable most (if not all) adults to receive their first dose by the end of the second quarter. That, combined with the tentatively encouraging Covid-19 case data following the school reopening, suggests the planned easing of restrictions in April and May remain on-track. In other words, little reason for the Bank to doubt its optimistic outlook for GDP for the rest of 2021.

That suggests that negative rates remain unlikely this year, barring a serious setback in the recovery process - and even then, we get the sense some MPC members will still take some convincing that this is a beneficial option.

It also means that the Bank will probably opt against offering any serious pushback against tightening expectations as they currently stand - even if, in practice, actual rate hikes are probably a 2023 story.

## Awaiting details on the future balance sheet guidance and the new 'green mandate'

Apart from that, there are two unresolved questions that we didn't get answers to today.

Firstly, how might the Bank will change its guidance on reducing the size of its balance sheet in the future? In the past, the central bank has stated it wouldn't reduce its asset holdings until the Bank rate had returned to 1.5%. But under the stewardship of governor Bailey, it looks more likely that this process will happen at a much earlier point in any tightening cycle - emphasising that QE is viewed as the favoured tool when it comes to adding and removing support at the margin.

Secondly, the Bank now has a new 'green' mandate, requiring it to support the transition to net-zero. Policymakers have formally signalled this will involve tweaks to the corporate bond purchase scheme, though we're still awaiting further details. In practice, this will probably mean giving greater weight to high-ESG scoring bonds in future reinvestments ([read more in our preview](#)).

## GBP: Upbeat outlook unchanged

Given that the central bank didn't deliver much of a surprise, it leaves our upbeat GBP outlook unchanged.

The Bank is not materially leaning against higher gilt yields and currency strength, which means GBP is set to continue reaping the dividend of the faster vaccination process. This vastly contrasts with continental Europe and suggests a potentially earlier and faster UK economic recovery in Q2. This favours GBP versus other European FX, and we expect EUR/GBP to reach 0.85 this month.

As the GBP outlook remains bullish, we also expect the GBP trading pattern to change. Compared to prior years, we now look for a period of frequent valuation overshoots (vs prior periods of undershoots) as the positive vaccine rollout effect replaces previous negative Brexit uncertainty. Indeed, this is the case right now, and EUR/GBP is trading in an undervalued territory – yet we don't see a need for a correction.

With the Fed being cautious and likely to preside over very negative front-end US real rates, this should facilitate a further increase in GBP/USD, towards 1.50 later this year.

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