

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



Source: Shutterstock

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.

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

The statement echos 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.

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

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.

Author

James Smith

Developed Markets Economist

james.smith@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.