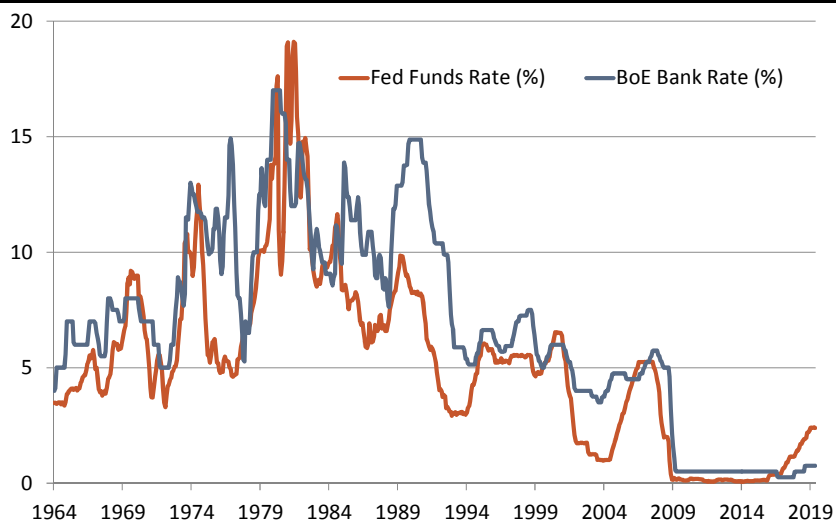


7 June 2019

## Heightened risks keep BoE on hold until 2020

### Trends in Bank of England and Federal Reserve policy rates are closely correlated



Monthly data. Source: Bank of England, Federal Reserve Board.

- Risks abroad:** As a highly financialised, medium-sized open economy, the UK cannot escape the winds of the global cycle. The current swell of risks linked to the Chinese slowdown, global industrial weakness, trade wars and wobbly financial markets casts a dark shadow over the near-term UK economic outlook. The recent downtrend in long-term bond yields for advanced economies reflects growing pessimism about the outlook for global growth.
- Here comes the Fed:** The recent inversion of the US yield curve – a frequent predictor of US downturns – signals what could be in store if the risks go badly wrong. With trade war uncertainty weighing on US domestic momentum more than before, as the fiscal stimulus of 2017/18 wears off, the Federal Reserve is likely to take some precautionary measures soon, to see to it that the US slowdown does not turn into a full-blown economic downturn. We look for the Fed to lower the funds rate by 50bp during the second half of this year.
- Risks at home:** The threat of a hard Brexit – 35% probability has weighed heavily on parts of the UK economy since the June 2016 EU referendum. While consumption and hiring have remained resilient, business investment is c12% below its pre-referendum trend. The ongoing Conservative leadership contest that will result in a new prime minister (PM) adds to the uncertainty. If the next PM is a hardline Brexiteer, the risk of a hard Brexit that could plunge the UK into an economic crisis may rise.
- The BoE's bind:** Bad economic policies – like Brexit – can cause inflation even as growth slows. Inflation expectations have risen to a post-Lehman high. Labour costs are rising as the labour market tightens. Meanwhile, productivity-enhancing capital investment that helps to contain inflation remains weak. While the BoE does not always track the Fed, our chart tells a clear story – quite often the BoE is in the same boat as the Fed. The forces that drive the US economy – still the biggest in the world – also affect the UK. The US and UK are now both exposed to the same factors that could derail the global economic expansion. We now look for the BoE to remain on hold over the course of 2019, having previously expected one hike in the second half of the year.
- Hawkish, but holding for now:** The BoE has signalled gradual and limited rate hikes for nearly two years. It has hiked just twice during that period. Probably, the BoE will stick with a hawkish bias as long as the UK economy remains firm. If, as the BoE expects, demand growth accelerates once Brexit is finally resolved, it will probably continue with its policy normalisation. Dropping its hawkish tilt soon, only to readopt it – probably in early 2020 – would make the BoE appear skittish and further weaken its steer on market expectations for monetary policy.
- Base case:** Monetary policymakers are reacting to the industrial downturn. With luck, precautionary rate cuts by the Fed, suitably dovish guidance from the ECB and a BoE decision to delay rate hikes until next year will be enough to get the western world through its current rocky patch. Thereafter, as long as the UK avoids a hard Brexit and global economic growth remains close to trend, the BoE will take further small steps to normalise UK monetary policy. We look for two hikes in 2020 starting in Q2.

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