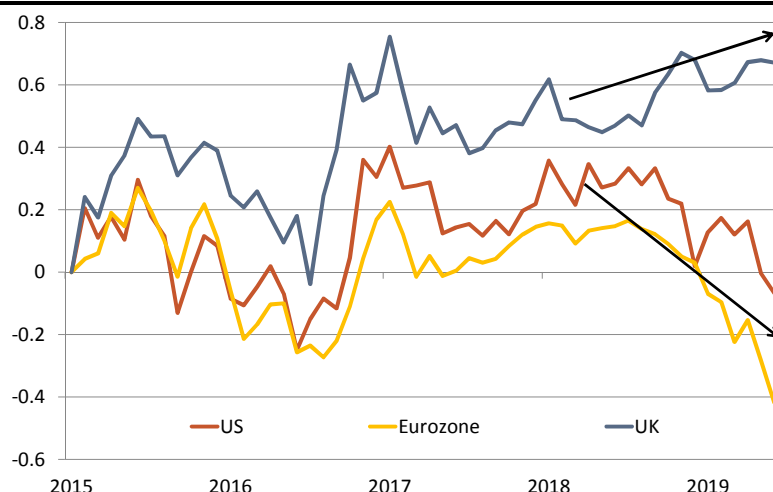


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28 June 2019

BoE: the odd one out

5 year/5 year inflation swap forward rates (ppt change since January 2015)



Monthly data. Source: Bloomberg

- Here come the big guns:** Reacting to the continued slide in manufacturing and export-orientated industries, political uncertainties and a drop in economic confidence, some key central banks are likely to act soon. After hiking rates as recently as December 2018, the US Fed has changed its tune considerably lately. As an insurance policy against a further weakening of US momentum, we look for the Fed to cut rates by 25bp in July and again in October. The ECB soon looks set to cut rates and restart its massive bond purchase programme to lean against disinflationary pressures and put the Eurozone recovery back on track.
- The odd one out:** As a rule of thumb, where the big US and Eurozone head, the relatively small UK – wedged between the two – is close by. The same (usually) goes for the BoE, since it normally faces a similar set of economic conditions in the UK as the Fed within the US and the ECB for the Eurozone. However, as recently as this week, BoE policy-makers – including Governor Mark Carney – continued to guide the market towards gradual rate rises over the medium term, despite data showing that the UK economy seems to have softened in line with the global trend in Q2.
- Diverging inflation expectations:** Market-based UK inflation expectations jumped in June 2016 after the Brexit vote. An improving global outlook and the Trump stimulus lifted inflation expectations in the US and Eurozone shortly thereafter. Throughout 2017 until mid-2018, inflation expectations remained elevated in major parts of the Western world. In the US and Eurozone, they started to soften by late 2018 and have dropped materially in 2019 as the risks to the global outlook have grown. In the UK, however, inflation expectations have risen further. Despite a small drop in recent months, GfK survey data suggests that consumer inflation expectations remain at a near post-Lehman high.
- Bad economic policies cause inflation:** Our chart highlights the early consequences of Brexit. While demand growth has remained resilient, uncertainty about the future rules that will govern UK-EU trade has weighed on the supply side of the UK economy. Households have continued to spend while firms have held back capacity- and productivity-enhancing investment that helps to contain inflation. Despite growing risks to global demand, which weakens inflation expectations elsewhere, the BoE still has to contend with the inflationary legacy of the Brexit vote.
- The BoE's big bets:** Of course, if things go badly wrong, that is, if the UK ends up with a hard Brexit (35% risk) or the global economy enters a genuine downturn, the BoE would change its tune fast. However, that is neither our, nor the BoE's, base case. The BoE continues to guide markets towards a further normalisation of monetary policy on the basis that the current global risks will fade and the UK will avoid a hard Brexit. On this basis, further rate hikes would be prudent to ensure inflation expectations come down and actual inflation remains close to the BoE's 2% target. For the remainder of 2019, however, we expect the BoE to remain on hold while continuing with its hawkish bias. But in 2020, if the risks do not materialise, we look for the BoE to hike rates twice (in Q2 and Q4).

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