Daiwa's View

Focus on UK pound is shifting from fiscal policy to BOE

- BOE implemented a 75bp rate hike
- Hike is large, but message is dovish

Fixed Income Research Section
FICC Research Dept.

Strategist
Kengo Shiroyama
(81) 3 5555-8755
kengo.shiroyama@daiwa.co.jp

Senior FX Strategist
Kenta Tadaide
(81) 3 5555-8466
kenta.tadaide@daiwa.co.jp
Daiwa Securities Co. Ltd.

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BOE raised policy interest rate by 75bp to 3%

On 3 November, the BOE raised its policy interest rate (Bank Rate) by 75bp to 3%. The hike is the biggest in the current tightening cycle, and in addition the BOE showed a stance of continuing rate hikes. Despite that, the UK pound was sold against major currencies. We also saw a rise in UK gilt yields, led by the long-term zone, not by the short-term zone. This led to bear steepening of the yield curve.

UK assets were probably sold because the message from the BOE was interpreted as a dovish rate hike. In his press conference, BOE Governor Andrew Bailey implied that the terminal rate may be lower than the rate priced in by the market. In addition, in the Monetary Policy Report, economic and price projections were lowered from those in previous reports. The report says that (1) the premise of the Bank Rate is the path of the rate implied by financial markets in the seven working days leading up to 25 October, and (2) the path rose to a peak of around 5.25% in Jul-Sep 2023. Reflecting these dovish messages, the market may have judged that the BOE would fail to rein in inflation as its measures would not be sufficient.

Cut in GDP and CPI projections

The BOE raised its FY22 GDP growth rate projection, considering the government measures to cope with energy prices, which is expected to support domestic demand. However, it projects that GDP will post negative growth from 2023 to 1H 2024 and then recover only moderately. Currently, the output gap is clearly positive, but it is expected to fall into negative territory from 2023 and decline to -3% toward end-2024.

In line with the cut to GDP growth rate projections, CPI forecasts were also lowered. In 2022, CPI inflation is expected to hit a peak of +11% y/y, but this was lowered from the previous projection of around +13% as of August, taking into consideration the impact of the government measures to cope with energy prices. Under the assumption that energy prices will fall in line with the market's future prices, the BOE projects that CPI growth will slow down from FY23 onwards because of a decline in energy prices' contribution to CPI inflation (y/y). CPI projection for Oct-Dec 2023 is still high at +5.2% y/y, but it is expected to fall to +1.4% in Oct-Dec 2024.

In the alternative scenario of constant interest rates at 3%, as well, CPI is projected to slow down to +2.2% in Oct-Dec 2024 and +0.8% in 2025. Regarding the time frame for returning CPI inflation to the BOE's policy target of around +2%, there is little difference between the two scenarios.

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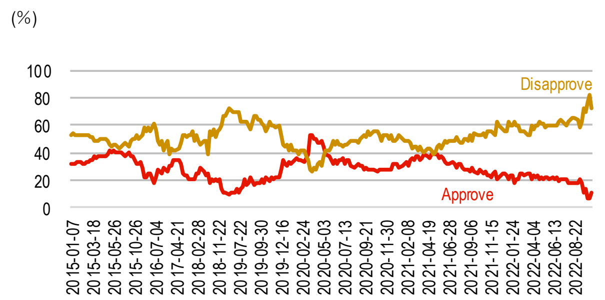
Inflation projections unlikely to be revised upward due to fiscal factors

The UK government postponed its plan to announce the medium-term fiscal policy from the initially scheduled 31 October to 17 November. Accordingly, the BOE's economic projections only reflect fiscal measures that have already been disclosed. However, YouGov's opinion poll showed that the government's approval rating as of 31 October was still low at 11%, a slight rebound from the 6% (Chart 1). Consequently, the likelihood of the government formulating new measures to cut taxes is low. Given this, we do not think that the current BOE's inflation projections will be revised upward due to fiscal policy factors.

Based on the aforementioned economic projections, Governor Bailey appeared to suggest that the central bank would not raise interest rates beyond 5%. This was also implied by Deputy Governor Ben Broadbent on 20 October. However, liquidity of the UK gilt market, which faced turmoil after the announcement of tax cut measures in late September, has not yet recovered. On top of this, the messages from the BOE were dovish compared to the Fed and ECB, both of which are still maintaining a tightening stance. In our view, this is what led to selling of the UK pound and UK gilts.

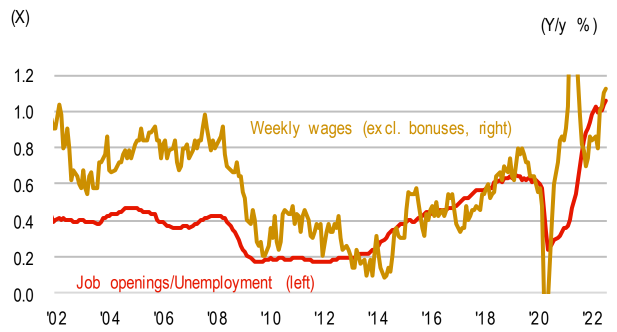
That said, the BOE's stance of continuing rate hikes is unchanged. Although inflation is expected to calm down going forward, the BOE says that there is an upside risk. It first pointed out the possibility that the disruption to the supply of gas from Russia to Europe may raise gas prices in the future to the level higher than the futures prices used as assumptions for forecasts by the Monetary Policy Committee (MPC). In addition, the BOE referred to the tight domestic labor market (Chart 2) and risks that wages and corporate price-setting activities would increase more than expected if consumers' inflation expectations do not fall back. Given these upside risks, we think that the BOE will continue to hike rates.

Chart 1: UK Government Approval Rating



Source: YouGov; compiled by Daiwa Securities.

Chart 2: UK Labour Market



Source: Office for National Statistics; compiled by Daiwa Securities.

No change to policy to reduce BOE's balance sheet

The BOE has not changed the policy of reducing its balance sheet, either. On 1 November, the BOE started outright sales of government bonds, which had been postponed. It appears that this has not resulted in major damage to the UK gilt market for now. In addition, the BOE's Market Participants Survey in November, aligned with the meetings of the MPC, showed that expectations for the amount of UK government bonds held by the BOE did not change substantially from those in the September survey (Chart 3). This appears to be based on the view that (1) depleted liquidity would not disturb sales of government bonds as the outlook suggests that it would take some years before UK reserve deposits fell below the minimum level of liquidity required by private-sector banks, as shown in a 4 November speech by Andrew Hauser, BOE Executive Director for Markets[1], and (2) liquidity is unlikely to dry up because even if reserves fell below the minimum level of liquidity, commercial banks could use the Short Term Repo facility[2] introduced by the BOE on 4 August.

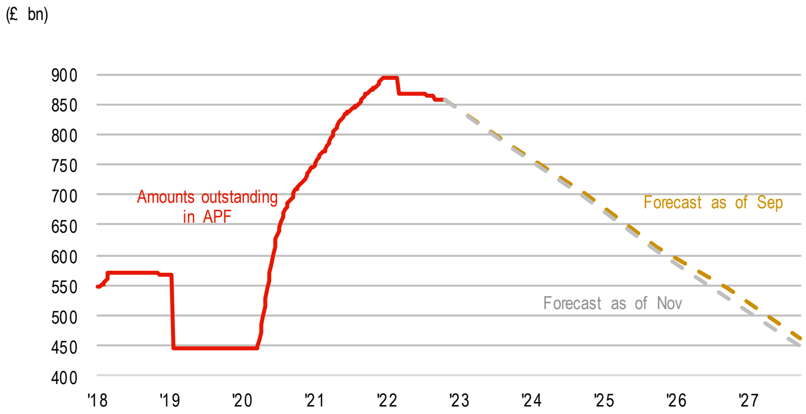
1 https://www.bankofengland.co.uk/-/media/boe/files/speech/2022/november/thirteen-days-in-october-speech-by-andrew-hauser.pdf?la=en&hash=542C9233D0

2 https://www.bankofengland.co.uk/markets/market-notices/2022/august/explanatory-note-on-operational-implications-of-apf-unwind

Despite ongoing rate hikes by BOE, UK pound is likely to continue to meet upside resistance

That said, from the viewpoint of forex market, we have seen bearish performance of currencies in nations where central banks have started to reduce the size of rate hikes, such as the Australian dollar and Canadian dollar. As the BOE showed a dovish stance, the UK pound is also likely to continue to meet upside resistance until the terminal point of global monetary tightening comes in sight.

Chart 3: Forecast for Amounts Outstanding in APF



Source: BOE; compiled by Daiwa Securities.

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