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Two in Twenty?

Bank of England Post-Meeting Comment

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Summary

- As expected, the Bank of England MPC kept rates unchanged at 0.75%. There was again a dovish vote split as Michael Saunders and Jonathan Haskel voted for a 25 bps cut
- Yet the majority of the MPC found it too early to judge "how material" the outcome of the election would be for their outlook
- We don't think that the economic uncertainty around a disruptive change to the UK's trading relationships is unlikely to vanish anytime soon
- As Brexit will continue to cast its shadow on the UK economic outlook, we expect two rate cuts in 2020

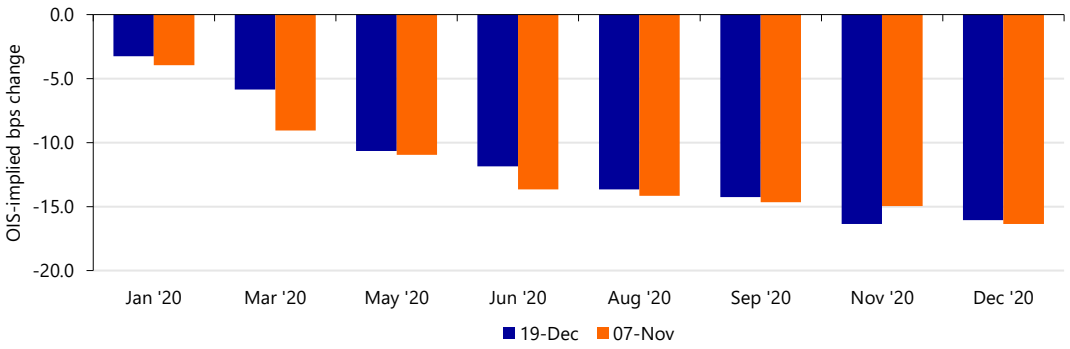
Seven to two

As expected, the Bank of England MPC kept rates unchanged at 0.75% and there were no changes to the asset purchase facility. There was again a dovish vote split on rates as Michael Saunders and Jonathan Haskel voted for a 25 bps cut, but no other MPC members felt compelled to join the two doves.

The monetary policy summary and the minutes provided no real clues of a change in thinking. The recent economic data were pretty much in line with the forecasts as set out in the November report, and a majority in the MPC believes that GDP growth will start to rise above potential growth next spring. They have pinned their hopes on lower uncertainty, easier fiscal policy and a slight pick-up in global growth. At the same time, they found it too early to judge "how material" the outcome of the election or the phase 1 trade deal would prove to be for this outlook.

The two doves pointed at the weakness in the labour market. Employment growth is slowing, and further weakening appears likely given the recent trend in vacancies. Surveys also indicate that there is further downside risk to private sector earnings growth, which fell to 3.5% in the three months to October. Their global outlook is also more bearish, while the entrenched Brexit uncertainties posed a further downward risk. They favour a "prompt response" to these downside risks, and we indeed think that this is the most likely way forward.

Figure 1: Markets assign a 70% probability of a rate cut in 2020



Source: Bloomberg, Rabobank

The shadow of Brexit…

Last week's election has completely redrawn the map of the United Kingdom, and this finally allows Brexit to move forward. But even though the prime minister's slogan to "Get Brexit Done" sounds simple and straightforward, very tough negotiations lie ahead. The government doesn't appear to have formulated an official negotiating strategy yet, other than Johnson's tactics to rip out the steering wheel and committing to have Brexit completed by the end of 2020. Starting from tomorrow, the government will aim to pass legislation prohibiting any extension to the transition period beyond December 2020.

While this could be perceived as sabre rattling or as something to take seriously-but-not-literally, it does underline the stark reality of a new cliff edge at the end of next year if no agreement on a future relationship is reached. The UK will then be out of the EU on WTO terms, and there will be the immediate imposition of tariffs, quotas, and lots of regulatory checks at the border. And even if an FTA is reached, with or without delay, the government's unwillingness to follow EU standards and regulations in the future also means that only a very narrow FTA looks to be within reach. This is not without economic costs: in 2018, the government published an analysis which suggested that such an arrangement would have a negative impact on GDP by 6.7% in the long run. The government has yet to publish a more up-to-date impact assessment.

So even if the prime minister will claim that Brexit will be "done" on January 31, we don't think that the economic uncertainty around a disruptive change to the UK's trading relationships is unlikely to vanish anytime soon. Instead, we expect Brexit to continue to cast shadows on the UK economic outlook, and have pencilled in an annual growth rate of just 0.8% in 2020.

… finally leads to rate cuts?

The forward guidance of a slow rise in rates provides less and less actual guidance to the markets, as it has become explicitly conditioned on a happily-ever-after world. It states that *"if global growth fails to stabilise or if Brexit uncertainties remain entrenched, monetary policy may need to reinforce the expected recovery in UK GDP growth and inflation. Further ahead, provided these risks do not materialise and the economy recovers broadly in line with the MPC's latest projections, some modest tightening of policy, at a gradual pace and to a limited extent, may be needed to maintain inflation sustainably at the target."*

We think the former scenario is the more likely scenario. The MPC has always maintained a somewhat ambiguous approach regarding Brexit, not wanting to paint itself into a corner, but this is becoming increasingly difficult to maintain. Whilst the economy has avoided falling into a technical recession, this is mostly a discussion on technicalities as the level of GDP in October was actually lower than it was in February. The PMI's showed no material signs of improvement yet and even reported that manufacturing production fell at its sharpest rate in almost eight years in December. Sustained economic weakness will ultimately lead to lower inflation, which is currently already at 1.5% due to falls in regulated prices and may trend even further downwards in the first half of next year.

The uncertainty surrounding Brexit is emblematic for the UK economy, but also for the Bank of England. The successor of Governor Carney, who will leave right after the January 31 news conference) should have long been announced already, which would allow him/her time to prepare for this role. A decision is now expected within days.

Whoever may land the job, the new Governor will be handed an economy that is being put under strain by Brexit. Business investment has been in the doldrums for almost two years and cracks have also started to become visible in the labour market. **The uncertainty is hitting the UK economy hard and we therefore expect two rate cuts in 2020.**

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