All aboard the easing-train!

Bank of England Preview

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Summary

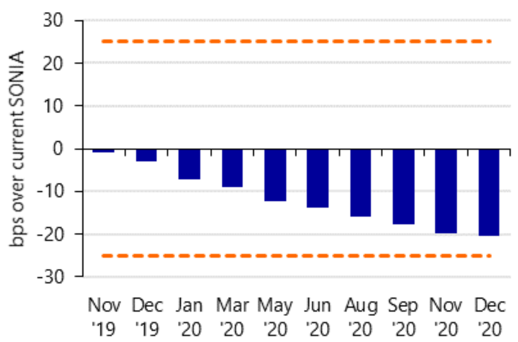
- We expect the Bank of England to leave the policy rate unchanged at 0.75% on Thursday 7 November. This is also the consensus view and GBP OIS implies virtually no chance of a move in either direction at this week's meeting
- Whilst the OIS market is –on balance– still looking for a rate cut in the first half of 2020, the implied probabilities have closely tracked those of a no-deal Brexit
- The immediate threat of a no-deal Brexit has been averted, but the uncertainty prevails. The UK is heading for a Christmas election, and even Johnson's Brexit-deal leaves open a wide range of future possible trading relationships, including no trade agreement at all
- Business investment has been in the doldrums for almost two years, while cracks have also started to become visible in the labour market. There is a good chance that sustained weakness on this front tilts the balance within the MPC. We now expect two rate cuts in 2020

We don't expect the Bank's Monetary Policy Committee to change its policy settings at this week's meeting and the decision to keep rates unchanged at 0.75% is likely to be unanimous. We do however look for any indications that the MPC is becoming more worried by the "entrenched uncertainties" that constrain the British economy.

The Bank of England's forward guidance currently directs the market toward a slow rise in interest rates, yet we judge it as unlikely that the MPC will be able to live up to its guidance. While the economy is likely to avoid a technical recession due to a relatively strong summer, the underlying trend remains firmly towards softer growth. The headwinds from a major global slowdown and the never-ending uncertainty surrounding Brexit –almost regardless of the outcome of the December election– are likely to continue to be a drag on investment and external trade.

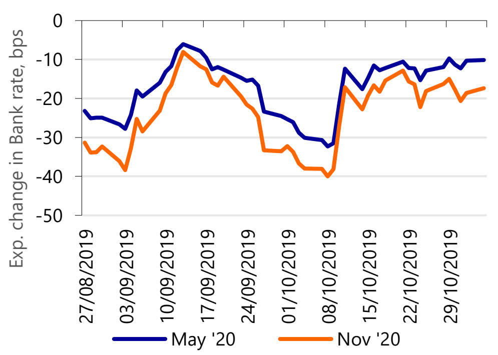
The cracks in the labour market have started to become more visible. We think there is a good chance that continued weakness on this front could tilt the balance within the MPC. **We have therefore changed our call and expect the Bank of England to board the global easing train. This could already be precipitated by a dovish shift in this week's meeting.**

Figure 1: What forward guidance? The MPC says 'up', the market says 'down'



Source: Macrobond

Figure 2: ... but markets re-priced the risk of a rate cut as a no-deal Brexit had been averted



Source: Macrobond

Uncertainties won't subside anytime soon

The persistent uncertainties related to Brexit weigh heavily on business investment decisions and aren't likely to subside anytime soon. A no deal Brexit is off the table for now, but fears may again rise ahead of the new January 31 deadline. And even if the current Withdrawal Agreement Bill gets a quick pass in a new parliament, it won't take long before businesses will realise that the divorce was just phase one of Brexit. There will soon be new question marks over the length of the transition period towards the still undefined future relationship between the UK and the EU.

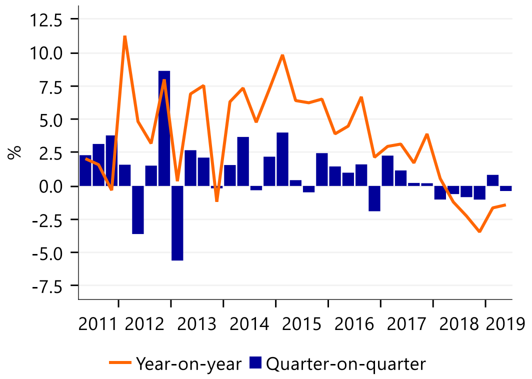
It has been agreed that the UK will continue to participate in the Single Market and the EU Customs Union until December 2020. This transition period can be extended once, by a maximum of two years. A joint committee already has to decide on this before July 1, just five months after the new Brexit-deadline. Boris Johnson has vehemently ruled out an(other) extension, under pressure from the Brexiteers in the Tory ERG. He might still change this position –we all know how much his do-or-die pledges are worth– but it's not sure whether he will have the room for manoeuvre after the election (*if* Johnson becomes Prime Minister, of course).

It is expected to take much, much longer than eleven months to negotiate a comprehensive free trade agreement such as 'Canada-plus'. The 'plus' in Canada-plus refers among other things to a mutual recognition of each other's regulations, but the decision to shift the texts on level playing field to the political declaration suggests that the UK may decide that it wants to diverge on this. If the UK indeed uses Brexit to undercut EU regulations –in order to strike deals with the US, for example– the best trade deal that it can probably get with the EU is a very basic one; note that various EU leaders have frequently raised the danger of the UK developing into another competitor on the continent's doorstep.

There is an inverse relationship between UK divergence and the depth and breadth of any future trade agreement with the European Union. There is a risk that the current withdrawal agreement will therefore prove to be the precursor of a hard but managed Brexit in December 2020. The UK risks raising high barriers to trade with a large economic bloc at its doorstep in order to get as much freedom as possible to trade with countries further away. It's trying to defy gravity, and that typically doesn't work out well. **The belief that Johnson's deal should still be passed quickly in order to provide businesses and households with certainty is misguided. In any case, another cliff-edge looming at the end of 2020 does surely not provide this certainty.**

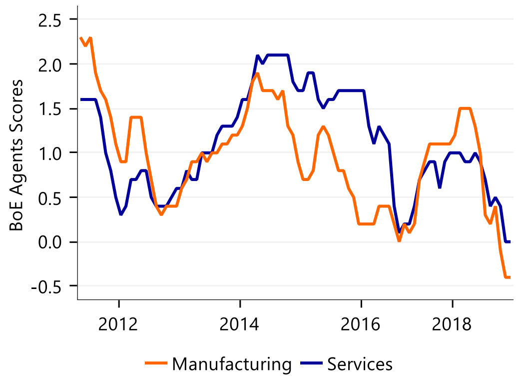
Meanwhile, business investment has already been in decline since early-2018 (figure 3), and has in fact decoupled from the other G7 economies, whereas the outlook remains weak as well (figure 4). This is a source of concern: weak investment is not only a drag on current growth, but also on long-term potential growth. The UK's track record on productivity since the financial crisis has been a source of concern for quite a bit, and the relentless uncertainties only exacerbate this.

Figure 3: Business investment declines...



Source: Macrobond

Figure 4: ... and investment intentions are weak



Source: Macrobond

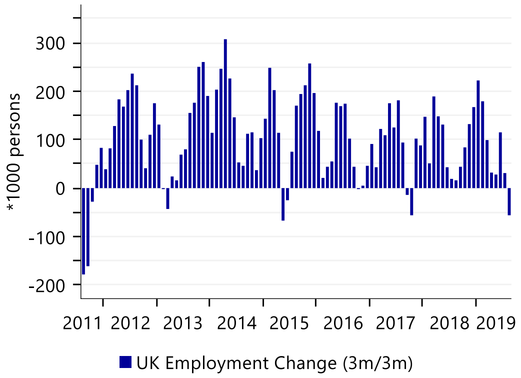
Cracks in the labour market?

A distinguishing feature of the UK economy is that the growth in investment and employment has strongly diverged over the past two years. We've explained here that firms have responded to increasing demand by hiring more workers –which is less costly to reverse if things eventually do go bad– rather than make long-term commitments and investment in new capital equipment.

It is therefore particularly worrying that the employment outlook has started to soften as well. The labour market data for August added to earlier survey evidence that the slowdown in demand has started to impact company hiring decisions. Employment dropped by 56,000 in the three months to August and the employment rate ticked down from 76.1% to 75.9%. This is still a high level and it is a relatively volatile series, but it does seem to suggest that the jobs market has lost its immunity to Brexit uncertainty. This had already been flagged by job vacancies data (figures 5 and 6), which continued their decline last month. In the three months to August, there were an estimated 813,000 vacancies, which is 34,000 fewer than this time last year. The vacancy rate is falling at its fastest pace since 2009. **This raises the suspicion that employment growth will flatten further and that the current 4% rise in average weekly earnings could indeed be short-lived, especially if the uncertainties regarding the outlook persist**.

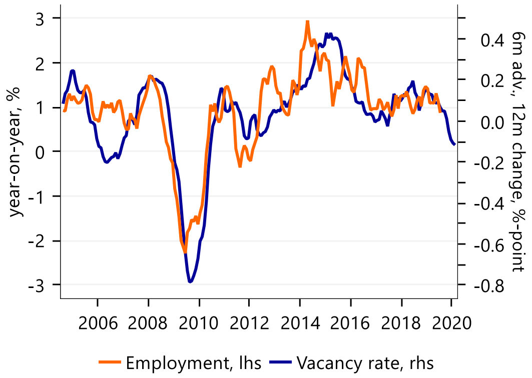
Any signs that the jobs market cools further will only reinforce the dovish shift of the MPC.

Figure 5: Employment growth softens...



Source: Macrobond

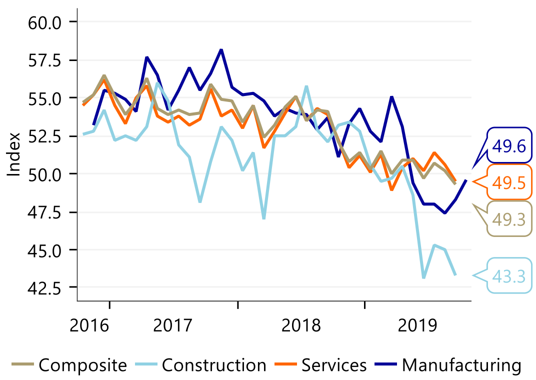
Figure 6: ... and may decline further



Source: Macrobond

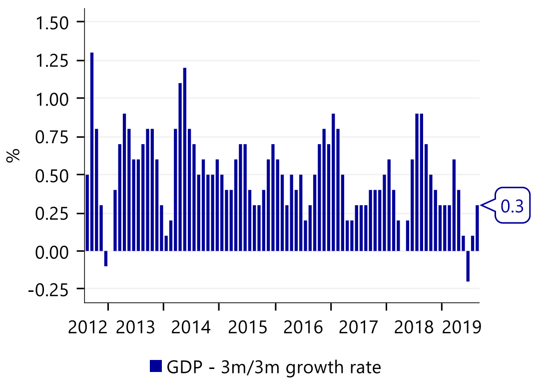
Whilst survey indicators have a tendency to exaggerate the impact of political uncertainty on actual economic output, they also produce a clear signal that the underlying trend is firmly towards softer growth. The manufacturing PMI has picked up to 49.6 in October, but this appears –again– mostly be due to stock building ahead of the October 31 deadline. But with all three sectors reporting sub-50 readings, and having slowly but steadily regressed towards these levels, the signal from the PMIs is fairly ominous.

Figure 7: Sub-50 readings all over the place



Source: Macrobond

Figure 8: GDP growth has slowed down



Source: Macrobond

Outlook

The MPC has always maintained that its response to a no-deal Brexit wouldn't be automatic and that it will depend on demand, on supply and where the exchange rate is heading, suggesting that it could raise interest rates should it need to counter rising inflation (-expectations) caused by a sudden drop in the pound. The risk of a no-deal has been averted for now, but might rise again after the election. It is likely that the MPC will maintain this ambiguity, but Governor Carney has already revealed that this balance is not "equally weighted" and that the MPC is more likely to cut interest rates back toward record lows. **The changing external environment, with slowing global growth and both the Fed and the ECB easing their policy stance, has surely contributed to this shift in balance.**

Our base case with regards to Brexit has always been an extension followed by a general election. It was fairly straightforward to analyse how enormously difficult it was to have a scrutinised deal that satisfied the UK government, the Brexiteers, the DUP, and a small number of moderates. But it will be impossible to say anything about the outcome of the election with any degree of certainty. **The polling numbers are all over the place, the party system is in flux, and the UK's first-past-the-post system leads to tactical voting that can't be predicted on a national scale.**

Regardless of which party or coalition wins, however, it will take long before we get any clarity on Brexit. If the Tories win their desired majority and Johnson's deal gets a quick pass, there will be speculation of a new cliff-edge in December 2020. Or if Labour is able to form a minority government with support from the Liberal Democrats and the SNP, we could expect new Brexit negotiations followed by a People's Vote. This will probably take more than the six months that Corbyn has currently promised his potential voters. **There are also plenty of other scenarios that simply can't be ruled out at this stage**.

The uncertainty surrounding Brexit is emblematic for the UK economy, and also for the Bank of England. The appointment for Governor Carney's successor should already have been announced by now, but is set to be delayed until after the general election. The Treasury appears confident that a new government will be in a position to make the appointment soon after the election. **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 have therefore changed our call. We now expect two rate cuts in 2020.**

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