Rabobank

Throwing in the towel

BoE Special

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Summary

- We have changed our Bank of England view, and now no longer expect a rate hike in May
- The UK economy is holding up relatively well and domestic cost pressures are rising, even as it faces Brexit uncertainties and strong global headwinds
- But as we've emphasised previously, the Bank's ability to hike interest rates depends on what happens in Westminster. Unfortunately, that's not much at all
- If these uncertainties re. Britain's withdrawal eventually dissipate, as we still expect, the MPC may re-find the confidence to talk about rising rates in the second half of the year
- But with the risk of a US recession in 2020 then looking imminent and the Fed looking at rate cuts rather than hikes, the Bank is at serious risk of being stuck in the same boat as the ECB
- Our below-consensus and below-market view implies that the risks are to the upside

The good

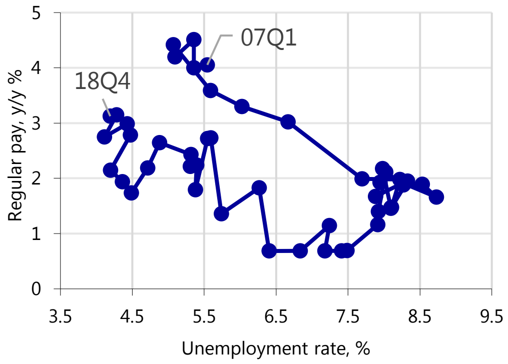
Why we were reluctant to change our call

Despite all the uncertainties surrounding the UK economy, the labour market has been doing remarkably well. In the fourth quarter of 2018 alone, 167,000 jobs were created. It signals that firms respond to higher demand by hiring more workers –which is less costly to reverse if things eventually do go bad– rather than investing long-term in new capital equipment. There's also plenty of anecdotal evidence that UK businesses have no choice but preparing for a hard Brexit, including finding out how to deal with potential changes in (trade) regulations and stock building. The latter is reported by a variety of surveys, but not (yet?) confirmed by official data.

The rise in staff numbers comes at a cost. Recruitment difficulties are rising with unemployment at a multi-decade low of 4.0%. The long-awaited pay recovery is therefore strengthening, suggesting that the Phillips curve isn't dead after all, just lower and flatter than in previous cycles. Average weekly earnings rose 3.4% compared to December last year, close to 1.5 pp above the rate of inflation. Combined with record-high employment numbers, the rise in real pay is feeding into higher retail sales. The series is volatile but up 4.2% on the year. The latest figures on tax receipts reflect strong growth in both income (+7.5%) and VAT (+5.6%) tax receipts. If it weren't for Brexit, the outlook for the UK economy would be much brighter than it is now.

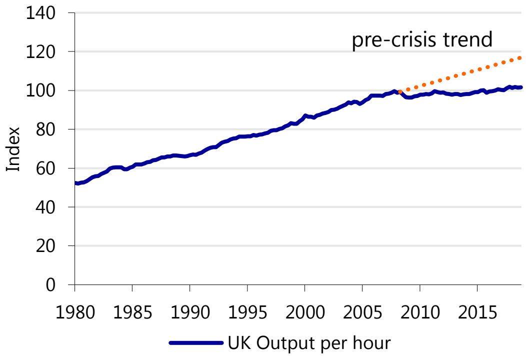
Whilst the strength of job growth is impressive, it also exposes the economy's Achilles' heel. Employment rose 1.4% over the past year (18Q4 vs. 17Q4), which is equal to GDP growth over that same period. In other words: productivity growth has been flat. In fact, the ONS just reported that output per hour in Q4 was -0.2% lower than it was in the same quarter last year. Estimates of labour productivity tend to be volatile, but output per hour is also just 2.3% larger than it was in 2008 Q2, which was the quarter before Lehman. Again – the response of firms to meet demand by hiring more workers rather than investing is a sensible decision in light of the uncertainties they are facing, but damaging to productivity and the economy's growth potential. The upshot of rising pay without a corresponding rise in productivity to compensate for this, is that domestic cost pressures are rising.

Figure 1: The Phillips curve is alive, only lower and flatter...



Source: Macrobond

Figure 2: ... but with barely any productivity growth (~0.4% ann.), cost pressures are rising



Source: Macrobond, Rabobank

The bad

Why global central banks are looking down, not up

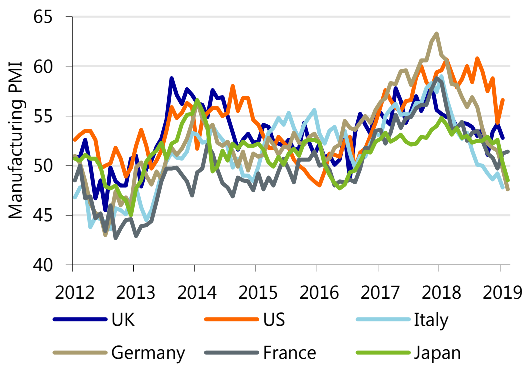
The external backdrop has deteriorated markedly over the past months. The manufacturing cycle – which always goes up and down at a faster pace than services – has been trending down since the early months of 2018, while trade tensions have eroded confidence even further (figure 3). The most recent PMIs suggest the trough isn't completely reached yet. UK industrial production has already declined to -0.9% on the year, which is bad but not *as* bad as in Germany or France. The survey suggests that export orders have dropped markedly. This is also part of a wider trend, and much of this is linked to the slowdown in China. While there are tentative signs that China is turning the corner – e.g. rising prospects of an understanding between the US and China, massive PBoC stimulus and relatively positive January trade numbers – it's way too early to sit back and relax. The data may be affected by the Lunar New Year and the January trade numbers from Japan and Korea were still very weak.

Therefore, the world's central banks are now looking down, not up. What follows is a selection of last week's headlines:

- Praet Says ECB Could Change Rate Guidance If Outlook Worsens
- ECB fears mount over intensifying trade war
- Fed's Mester Supports Ending Fed's Balance-Sheet Unwind This Year
- Kuroda flags BOJ's readiness to ease further
- A China Interest-Rate Cut May Be on its Way. But Which Rate?
- PBOC Launches Bills Swap Facility for Perpetual Bonds
- ... *and* Vlieghe says loose BoE policy more apt in no deal Brexit

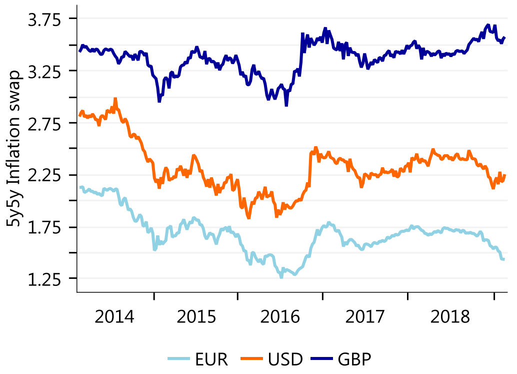
The manufacturing slowdown is directly related to last year's slump in energy prices, which in turn has been a main driver behind the deceleration of global inflation. Also in the UK, the headline rate was pushed down to 1.8% in January from 2.1% in December. Core inflation is holding up relatively well at 1.9% and should continue to find support in rising domestic cost pressures in the rest of 2019 and 2020. While the recent weakness in global inflation has significantly reduced the immediate urgency for a rate hike, market expectations of inflation have therefore remained anchored. The 5-year/5-year inflation swap rate is 3.55%, just a shade under the recent high of 3.7%. Meanwhile comparable USD and particularly EUR rates have recently plummeted to new cycle lows.

Figure 3: Global manufacturing is trending down – even before trade wars became mainstream



Source: Macrobond

Figure 4: Market inflation expectations remain firmly anchored – in contrast with EUR and USD



Source: Macrobond

The ugly

… or should we say 'a disaster'?

And then there's Brexit. Last week, yet another parliamentary vote passed without any change of course or significant progress. Wednesday's meeting between May and Juncker was reportedly 'thin on detail' with the latter being not very optimistic when it comes to avoiding a no-deal. He's right about that: the Feb. 14 rejection of an amendment that was approved just 16 days previously highlights the difficulty of achieving a sustainable majority on Brexit in the House of Commons.

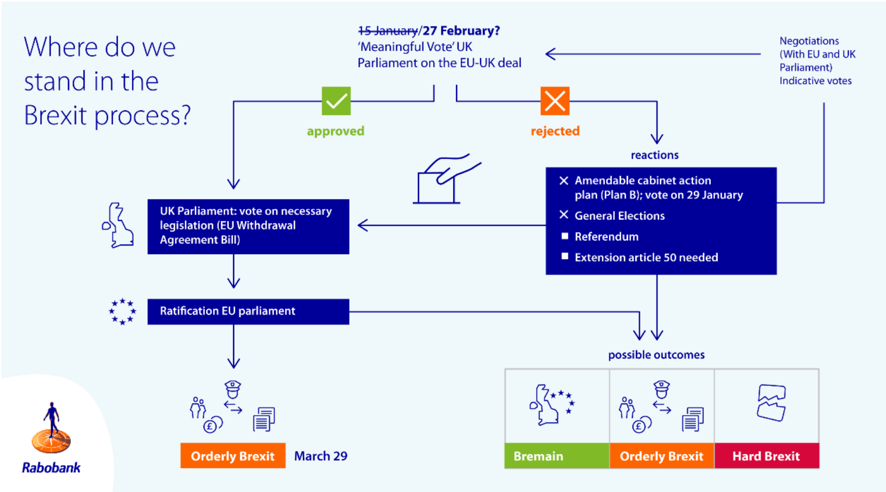
May's strategy of trying to frighten MPs into supporting her deal isn't bearing any fruit yet. The degree of tribalism is such that the MPs are demonstrating rock-hard confidence in their beliefs, not willing to compromise and to thrash out a Brexit that can command a broad majority. The decision by 8 Labour MPs and 3 Conservative MPs to form the Independent Group suggests that UK politics is in a flux – and that the two-party system is under severe stress. Even without anything that resembles a policy, they're already polling at 14%. It's refreshing, sure, but only complicates matters in the short-term. Will more MPs defect to this group? Will they succeed in their push to put May's deal to a public vote? We have to wait to find out.

Meanwhile, Parliament is scheduled to vote on a general Brexit motion on Feb. 27. It won't be a vote on the deal itself – because there is nothing new – but it will be a new chance for MPs to influence the course of Brexit and force May to rule out a no-deal exit and/or delay the divorce.

We learned this weekend that the new vote will be scheduled on March 12, a week before the European Council meeting. While March 29 is still the official deadline, there's a broad consensus in the market and among political analysts that an extension beyond that date is needed. But it is unclear whether this will be a short or long extension. It's relatively well established that EU27 member states will allow for a short one, which may even be requested in case of no-deal to mitigate its impact as much as possible. While this creates the risk of rolling cliff-edges and persistent uncertainty, any date after July 1 will in turn interfere with the EU elections. However, even the idea of a 21 month delay is currently being floated. In any case, an extension beyond July 1 would very likely mean that the U.K. also participates in the poll and elects MEPs. It's messy.

One of the few clear majorities in the House of Commons is against a no-deal Brexit, and there's increasing recognition that more time is needed. We therefore still regard an orderly Brexit as the most likely scenario, but expect that an extension will be needed to cobble together a majority. While this would be a relatively positive scenario given where we are now, it also means that the uncertainty persists into the second quarter of the year. The risk of a no-deal Brexit remains uncomfortably high, but as we explained here, we think that the MPC would serve the economy better by protecting its currency than by abandoning its guidance and slashing interest rates.

Figure 5: An extension is needed for an orderly Brexit



Source: Rabobank

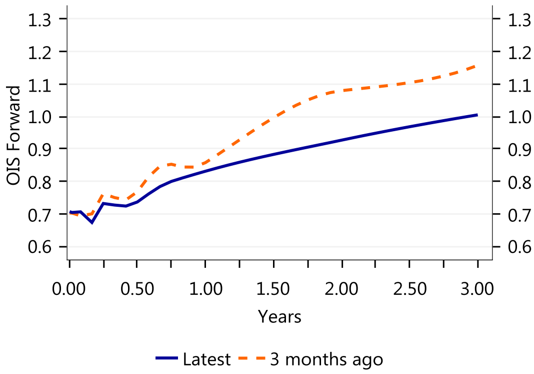
What to expect?

We expect that the Bank will maintain its guidance, pointing the market towards a gradual pace of interest rate hikes towards its final destination of c. 2.50% (see also here). But the market is not convinced (fig. 6) and attaches only a 40% probability to a year-end hike. With an extension of Art. 50 looking imminent, the uncertainty regarding Brexit will cloud the outlook even further than we initially expected. **We have therefore removed the May rate hike from our forecasts.**

But even if these clouds dissipate and some pent-up investment demand will be released, the Bank of England will still have a tough time raising interest rates. We suspect that they will try to squeeze in another hike in the second half of the year, if only to send a signal to GBP speculators, but the risk to the global growth outlook is currently tilted to the downside (e.g. a persistent slowdown in manufacturing that spreads to services, renewed trade tensions, a hard landing in China, a further rise in populism, a hard Brexit, etc.). **We think that the Bank of England will therefore join the Fed and the ECB in keeping its policy on hold this year**, but acknowledge that there's a clear upside risk to our view if *all* these big risk events do not materialize.

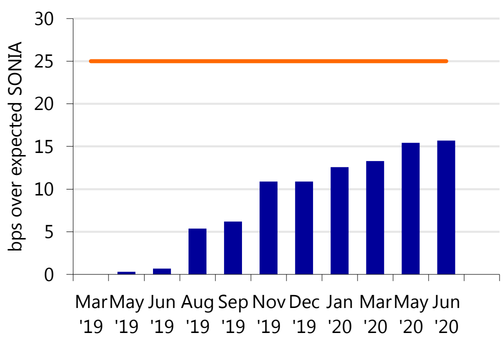
Unfortunately, we feel that 2020 won't be any easier. Our US strategist Philip Marey has now pencilled in a shallow recession in the US starting in the second half of 2020. At the very least, would we expect this to cause spill-over effects to the UK economy, preventing it from reaching the growth levels necessary for the Bank to hike. But of course this headwind is likely to be amplified by a much more agile Fed, who we expect to embark on a series of rates cuts from June 2020 onwards. Would the Bank dare to 'go against' the Fed? We would strongly doubt that.

Figure 6: SONIA forwards have flattened



Source: Macrobond

Figure 7: Markets are pricing 15 bps in 15 mths



Source: Macrobond

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