Market Update

Bank of England meeting: Not so fast

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Contributor

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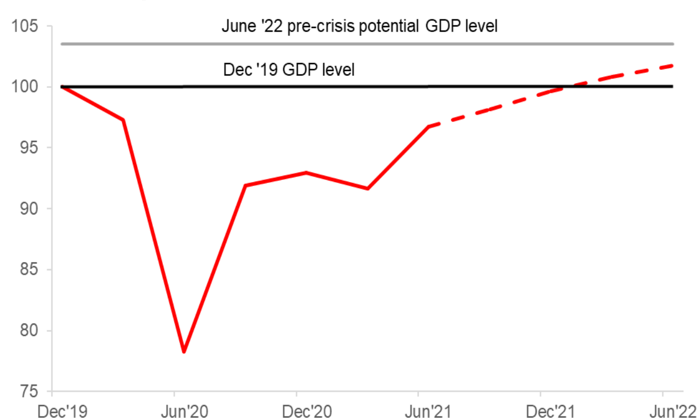
Today the Bank of England's Monetary Policy Committee (MPC) voted 7-2 to maintain the bank rate at 0.1% and 6-3 to keep the existing programme of UK government bond purchases at £875bn. The MPC held the line that inflation is likely to be transitory, peaking in April next year at just under 5%. Some investors were expecting a hike, and hence GBP moved lower, and closer to our year-end target of GBP/USD 1.34. The weakness in GBP supports our preference for large cap stocks in the UK market, while the BoE's mild downgrade to their growth and upgrade to their inflation forecasts support our recent downgrade of UK stocks to neutral.

- By the Governors' own admission, the decision not to hike was a "close call". Ahead of the meeting, the market was on the fence, so it was inevitable that either the bulls or the bears would be surprised, and there would be a reaction in GBP. With rates unchanged, GBP has shifted a large way towards our year-end target of $1.34, and we continue to believe that the MPC is unlikely to move on rates this year.
- The MPC pointed to some softness in consumer spending compared to previous expectations of very strong demand. This is not surprising given the steep rise in energy prices that will eat into household finances. We recently cut our UK equity overweight on the back of headwinds to the consumer through confidence and upcoming tax rises. This is also in addition to the Brexit risk that many smaller businesses continue to face.
- Uncertainty remains high. The MPC will try and navigate this by focusing on the upcoming labour market data and broader inflation expectations. Wages have surged in some parts of the economy that has been hit by shortages or by exceptionally high demand. With furlough having ended in September, the MPC will have a better idea of how this impacts labour supply ahead of the December meeting which, again, looks to be on a knife-edge.
- We agree that inflation is likely to be transitory and share the view that pressures should begin to fade in Q2. Therefore, while the MPC would clearly like to move some way towards normalising policy, any move would most likely to be incremental and modest, with the bank rate ending next year at 0.75%, according to our forecasts.

Softer growth and temporary inflation

The key judgement form the MPC is that the above-target inflation is mainly driven by supply shocks and is therefore temporary. They illustrated this by updating their views to show an excess of demand over supply of 0.5% of GDP in the fourth quarter. As supply shocks fade, this excess is forecast to decline to 0.25% by the end of next year; and by the end of 2024 supply should recover to the point that supply exceeds demand by 0.5%. The return to excess supply is driven by the fact that growth is still significantly below where it would have been had the crisis not happened, and therefore as the supply returns, so will the spare capacity.

Only in December will the economy have moved back to square one

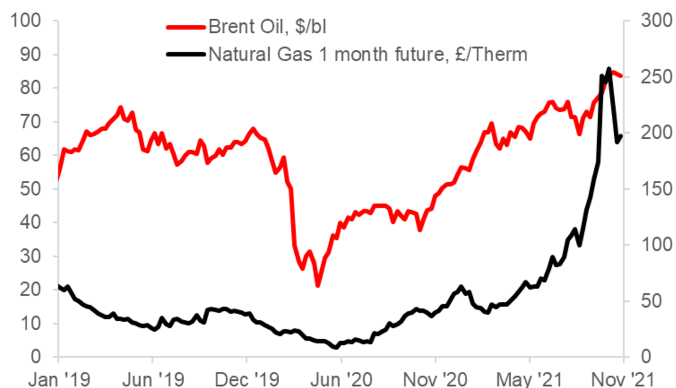


Note: dashed lines are HSBC forecasts.
Source: Bloomberg, HSBC Global Private Banking, as of 4 November 2021. Past performance is not a reliable indicator of future performance.

Disentangling the supply shocks is a hard task. The more obvious shock is through energy, where and quadrupling in prices in only 6 months has led to a steep rise in costs for suppliers. Oil, too, has seen a rapid recovery from the crisis lows as economies are kick-started across the global. Many of the effects were hard to forecast, with a number of idiosyncratic causes that drove Chinese demand for energy. These causes are likely to fade, in our view, and our forecast for Brent oil next year is closer to $70/bl. Supply bottlenecks have also rippled through the global economy as the "just-in-time" corporate supply chain comes up short during such a shock of demand and uncertainty.

Uneven demand has also played central part in pushing costs higher. Yet on a broad level the MPC's assumption, which we share, is that the dust will settle and the global economy should start to purr again later in 2022. Domestically, the UK also has to work through the shortages to labour supply which have been extenuated through Brexit.

Energy prices have risen sharply



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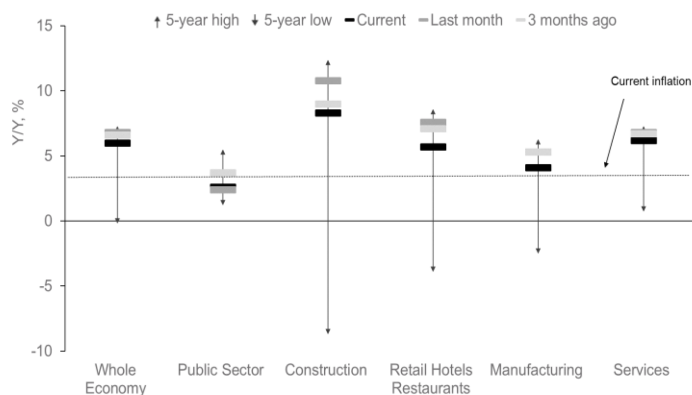
The shortage of workers in hospitality and transport is leading to wage pressures in these sectors. Part of this will be a structural rebalancing of the economy, with pockets of higher pay. However, evidence of a broader "wage-price" spiral is less apparent. Wage growth has been high, with weekly wages 6% higher than a year ago. Looking closer though, the gains can be more pinpointed to the re-opening sectors of the economy. Public sector pay is still below inflation while broader pay is flattered by compositional effects. Meanwhile there is evidence of pressures beginning to ease and the end of furlough should be more evident in labour data, which is released ahead of the next MPC meeting in December.

Pay is beginning to ease but the outlook is still uncertain



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This means there will be two key things that the MPC will monitor ahead of December's meeting: the health of the labour market and the inflation expectations. It was much higher expectations of inflation that led the market to believe the MPC would hike in a bid to quash corporates and employees bidding up prices and wages. However, market expectations are often

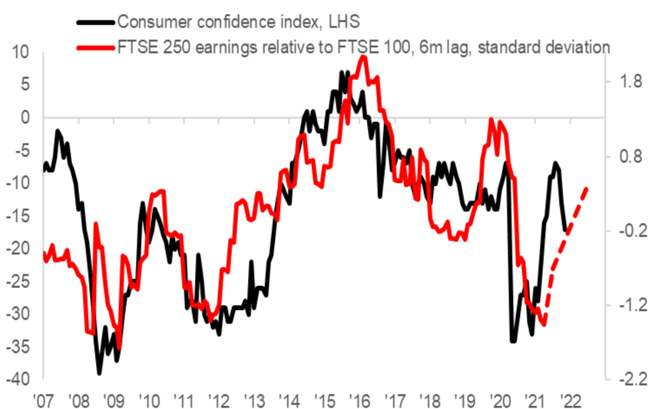
too influenced by short-term inflation will consumer expectations have been nearly as bullish.

That said the medium-term inflation forecast have moved higher than we expected and the BoE forecast of 2.2% by the end of 2023 is contingent on the bank rate ending 2022 at 1%. Therefore, we think that the MPC will begin to edge the rate higher with a risk that they could now move as early as December – again the market is on the fence over this one, so either way the next meeting will lead to some market volatility.

Why we moved UK equities to a neutral

Even though the MPC judges fiscal policy to be stimulative, income tax and corporate tax (19% to 25%) hikes early next year will pile on top of the energy squeeze on incomes. Brexit could be a potential downside risk, particularly to smaller businesses. As consumers grapple with these upcoming headwinds, confidence has fallen. Confidence tends to track the relative performance of the FTSE 250 over FTSE 100, and based on our thinking that this could get worse before it gets better, the larger cap stocks look a better bet. Also the Brexit and GBP risks point to the FTSE 100 too, where a majority of the earnings are in USD. The BoE has toned down their projected household consumption forecasts by 0.75% (to 4.75%) this year and 1.5% (to 7.75%) next year. On the back of the weaker consumer they forecast GDP growth a full percent lower next year at 5%.

More domestic earnings momentum tends to track consumer confidence



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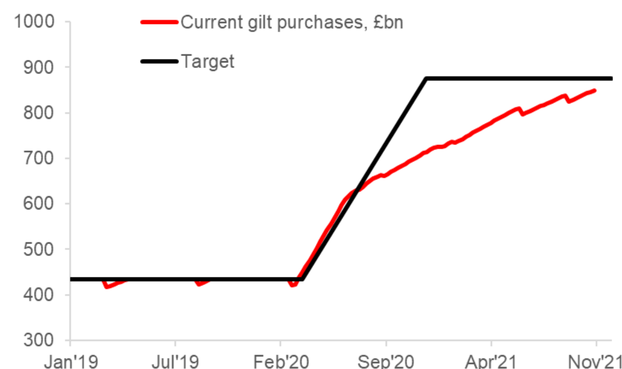
The BoE revised up its inflation forecast

		2021	2022	2021	2024
CPI Inflation (Q4, % yr)	Aug 2021 MPR	4.0	2.5	2.0	-
	Nov 2021 MPR	4.3	3.4	2.2	2.0
	Revision	0.3	0.9	0.2	-
GDP growth*	Aug 2021 MPR	7.25	6.00	1.50	-
	Nov 2021 MPR	7.00	5.00	1.50	1.00
	Revision	-0.25	-1.00	0.00	-

Source: Bank of England, HSBC Global Private Banking. Note: *GDP forecasts to nearest 0.25%.

What does support UK equities is the valuations: 12.6x forward earnings for the FTSE 100. That's why we stop short of being too negative on the outlook. Furthermore, while demand is less than originally forecast, it will still be strong an "stagflation" really is a long way off. Also policy remains loose – and the commitment to see the asset purchases through to the end will keep the BoE buying bonds until mid-December. From here gilt yields are more likely to fall over the medium term towards our Dec 2022 target of 0.75%.

There is still some QE left in the tank



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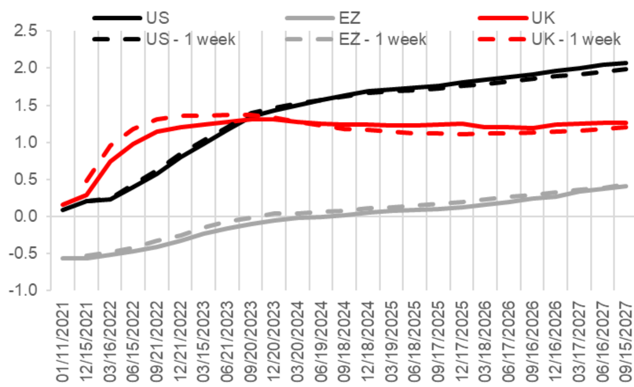
Less fear of a policy mistake

Last week forward rates in the UK looked quite unusual. Unlike the Eurozone or US the forward rate curve price in initially higher rates followed by a more likely cut in 2023/24. The interpretation of this is that the market though the MPC would go in too hard, too early, and then have to reverse course. Now the market is more in line with our thinking that there will be a total of 65bps hiking next year (although the market is still more hawkish at a bank rate of nearer 1% by Dec 2022).

The market pared back early rates expectations



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This shift lower of rate expectation has taken its toll on GBP, which would help up by the expectation of materially higher short term rates in the UK. With GBP having fallen to $1.35 at the time of writing there is room for a very modest further decline towards our $1.34 target.

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Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

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Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

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• Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures
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