

Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

Out of the B(l)oE

September 25, 2017

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Key takeaways

- Provides context for the sudden move of UK gilt yields, which have risen sharply since the release of surprisingly hawkish BoE minutes
- Argues that investors had previously paid too little attention to a number of warning signs, and that, indeed, a gradual shift in BoE rhetoric has been evident since March
- Central banks are exerting an underlining level of influence on all markets, and the importance of careful analysis of central bank policy statements in order to better understand monetary policy reaction functions

Full commentary

The Bank of England (BoE) caught most market participants off guard recently when it communicated plans to raise interest rates 'over the coming months'. Gilt yields jumped by more than 40bp and sterling gained six cents vs. the US dollar (see Figure 1).

The assumption until then had been that the BoE was more inclined to support the economy with loose monetary policy to offset the effects of Brexit, while looking through the short-term inflationary impact of the depreciation in sterling. So what changed?

The BoE's September Monetary Policy Committee (MPC) meeting minutes showed that members were becoming more confident about the economic outlook, pointing to better-than-expected activity in the third quarter; consensus GDP forecasts for 2017 growth have recovered from 0.3% immediately following the Brexit vote to 1.6% today, and 2018 forecasts are also edging up. Falling unemployment (the unemployment rate is at its lowest since 1975), and companies facing increasing difficulty in recruiting workers were taken as signs that economic and labour market slack was shrinking.

The committee appeared unfazed by the weakness in second quarter household consumption and business investment data (pointing out that these were early estimates and prone to revision), and blamed 'compositional effects' for suppressing wage growth. In our view, the key sentence in the minutes was:

A majority of MPC members judge that, if the economy continues to follow a path consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflationary pressure then, with the further lessening in the trade-off that this would imply, some withdrawal of monetary stimulus is likely to be appropriate over the coming months in order to return inflation sustainably to target.

The phrases 'a majority of MPC members', and 'over the coming months' appeared particularly hawkish. The reference in the minutes to the MPC undertaking 'a full assessment of recent developments ... in the context of its November forecast round' suggested that the rate increase could come as early as the next Quarterly Inflation Report (QIR) meeting in November.



Last week's market developments

Monday, September 18

- Eurozone CPI increased to 0.3% m.o.m. for August

Tuesday, September 19

- Germany ZEW Expectations of Economic Growth Survey Index increased to 17.0 for September
- US housing starts increased to 1,180k for August

Wednesday, September 20

- US existing home sales decrease to 5.35m s.a.a.r. for August
- UK retail sales ex-auto fuel growth increased to 1.0% m.o.m. for August

Thursday, September 21

- Japan All Industry Activity Index decreased to -0.1% for July m.o.m.
- US Philadelphia Fed Business Outlook Index increased to 23.8 for September
- Europe Consumer Confidence Indicator increased to -1.2 for September
- US Conference Board Leading Index increased to 0.4% m.o.m. for August

Friday, September 22

- Markit Eurozone Manufacturing PMI increased to 58.2 s.a. for September (preliminary estimate)
- Markit US Manufacturing PMI increased to 53.0 s.a. for September (preliminary estimate)
- Markit US Services PMI decreased to 55.1 s.a. for September (preliminary estimate)

Source: Bloomberg, data as of September 25, 2017



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There has also been a gradual change in rhetoric over the last few months. It started in March this year with the 8-1 vote to hold rates steady. External MPC member Kristin Forbes dissented by voting for a rate rise and the minutes showed 'some' members leaning towards the hawkish side. At the MPC's June meeting, three external members dissented in favour of a 25bp hike (Michael Saunders, Ian McCafferty and Forbes); the hawks claimed that the UK labour market was tight and that the prospects for investment and exports were solid. While the number of dissents fell to two (as Forbes left the BoE) in the August and September meetings, voices of dissent grew over the summer.

BoE Chief Economist Andy Haldane said in June that some withdrawal of the monetary stimulus provided by the BoE in August 2016 would be prudent in the second half of this year if data remained on track. Haldane had been perceived as a dove, so his comments were all the more surprising and forced market participants to face up to the possibility that above-target inflation could lead the BoE to raise rates later this year. Nonetheless, market expectations of a hike at either the November or December meeting remained stubbornly low until just recently (see Figure 2).

Then BoE Governor Mark Carney commented in late June at the ECB forum at Sintra, Portugal, that 'some removal of monetary stimulus is likely to become necessary if the trade-off facing the MPC continues to lessen and the policy decision accordingly becomes more conventional.' Finally, MPC member Gertjan Vlieghe, previously perceived as a dove, changed his views in a September speech, citing the erosion of economic slack and the re-acceleration of employment growth as reasons to end his 'lower-for-longer' view. With Haldane, Carney and Vlieghe all joining the hawkish camp, the 6-2 vote for no change could easily turn into a 5-4 vote in favour of a rate increase if economic data unfolds largely in line with the MPC's expectations, as laid out in its August QIR. Indeed, at the time of writing, short sterling futures are already pricing in a 72% probability of a November hike, and a two-thirds chance of a second hike by May 2018.

With 2-year gilts now yielding 0.45% compared to 0.15% two weeks ago, it would seem the front-end of the curve already reflects the probability of BoE rate increases in the near future. We believe, however, that this is likely a one-and-done (or at most two-and-done) policy change rather than the beginning of a series of rises. Currency-related inflation should be transitory in nature. It reduces consumer disposable income and so ultimately weakens domestic demand. Headline inflation is expected to peak in late 2017.

We are less convinced than Vlieghe that consumers have reached 'their desired debt-to-income ratios for now, and do not wish to deleverage further.' Instead, we believe the combination of a low savings rate, high household debt, and the potential deterioration in job prospects, suggests a vulnerable household sector. The slowdown in debt reduction is probably not by choice; rather, it likely reflects an inability to save because of subdued wage growth and the squeeze on real incomes. In fact, the weak consumption during the second quarter should not be ignored, even though it is an early estimate and subject to revision.

The softness in second-quarter business investment also warrants some attention. Economists have long predicted that Brexit uncertainty was likely to lead to less business investment. News about a 'status-quo' transition for a considerable period of time is encouraging but is unlikely to have a significant impact on business investment in the short term.

We are also skeptical about the BoE's confidence in future wage growth. There are still numerous global, structurally disinflationary forces at play. Unit labour costs may not rise if higher wages come from productivity improvement, but then again, manufacturers could choose to move away from the UK, meaning supply constraints would support wage gains.

In the near term, longer-dated gilts should be supported by light supply: net issuance is small once BoE reinvestment flow is taken into account. Liability-driven investment (LDI) flows are still positive for gilts and seasonal factors (November linker index extension, December coupon payment and reinvestment flows) also point to strong gilts demand through to the end of the year.

For gilts to sell off meaningfully from current levels, we would need to see a major breakthrough in Brexit negotiations, an unexpected fiscal expansion, or political paralysis reviving concerns about Jeremy Corbyn as prime minister.



This week's market developments

Monday, September 25

- Germany IFO business climate is expected to decrease to 115.2 for September

Tuesday, September 26

- US new home sales growth is expected to increase to 585,000 for August
- US Conference Board Consumer Confidence Index is expected to decrease to 120.0 for September

Wednesday, September 27

- US durable goods orders growth (prelim estimate) is expected to increase to 1.0% m.o.m. for August

Thursday, September 28

- US second quarter GDP growth (third estimate) is expected to remain at 3.0% annualized
- Japan national CPI growth is expected to increase to 0.6% y.o.y. for August

Friday, September 29

- UK second quarter GDP growth (final estimate) is expected to remain at 0.3% q.o.q.

Source: Bloomberg, data as of September 25, 2017



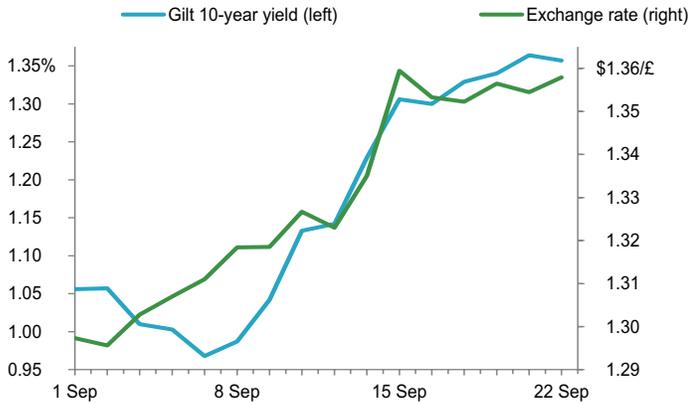
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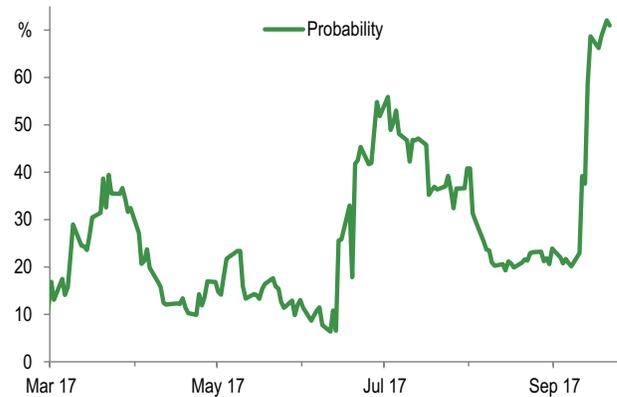
Charts of the Week

Figure 1: UK yields and exchange rate



Data as at 21 September 2017. Source: FactSet, BNP Paribas Asset Management

Figure 2: Probability of a hike by the BoE at the end of the year



Data as at 21 September 2017. Note: Average of probabilities for November and December 2017 meetings. Source: Bloomberg, BNP Paribas Asset Management



Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on September 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	1.00% - 1.25%	1.15%	November 1
ECB	-5 basis points	March 10, 2016	0.00%	-0.36%	October 26
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	October 31
BoE	-25 basis points	August 4, 2016	0.25%	0.33%	November 2

Source: Bloomberg; data as of September 25, 2017

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