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The Aerial View

Morning Briefing

Sep 16, 2020

BoE Flying Half-Blind into Q4

- **Risks are to the downside ahead of BoE September Meeting**
- **Budget delay means BoE may need to fly half-blind for a while**
- **Burden of adjustment for GBP should now be on growth**

Geoff Yu
Senior EMEA Market Strategist

Email >

The Bank of England is not expected to make changes in this week’s policy decision but we do expect the Monetary Policy Committee to conclude that risks to the economy are to the downside.

The impositions of new restrictions on social activity in itself is enough to inject renewed uncertainty into forecasts (especially for the services sector), but now the MPC will have renewed Brexit and fiscal uncertainty to contend with. Sterling’s recent weakness is certainly warranted, but the market probably needs to start shifting towards non-Brexit drivers to determine future price action.

We have previously highlighted the impending labor market pressures and so far the government has not expressed any willingness to extend the furlough program, even on a targeted basis. Furthermore, the BoE also differs from peers in not expressing a stronger view to maintain employment protection programs.

Chief Economist Andy Haldane said recently that it was not an efficient use of fiscal resources to support the businesses which "will probably not make it through" and the jobs which "may well not be coming back." In essence, if labor market (and wider economic) scarring is going to happen, it is best to let it happen immediately and let industrial policy direct government spending towards economic restructuring.

Tuesday’s ILO jobs data are pointing to serious challenges as total payrolls and hours worked continue to decline, but we still believe the figures do not fully reflect the dependency on the furlough scheme (there is a 4-4.5 million gap between ONS and government estimates of furloughed workers).

Elsewhere, the BoE’s Agents Reports also point to near unprecedented slack in the labor market in the form of collapsing difficulties in recruitment and more worryingly, employment intentions (see chart below). The agents are based across the country and inform the BoE’s decisions. Given the low total score provided by the agents, the economic adjustment which appears to be "hollowing out" cities is clearly not just a London phenomenon.

Employment Scores - BoE Agents' Report

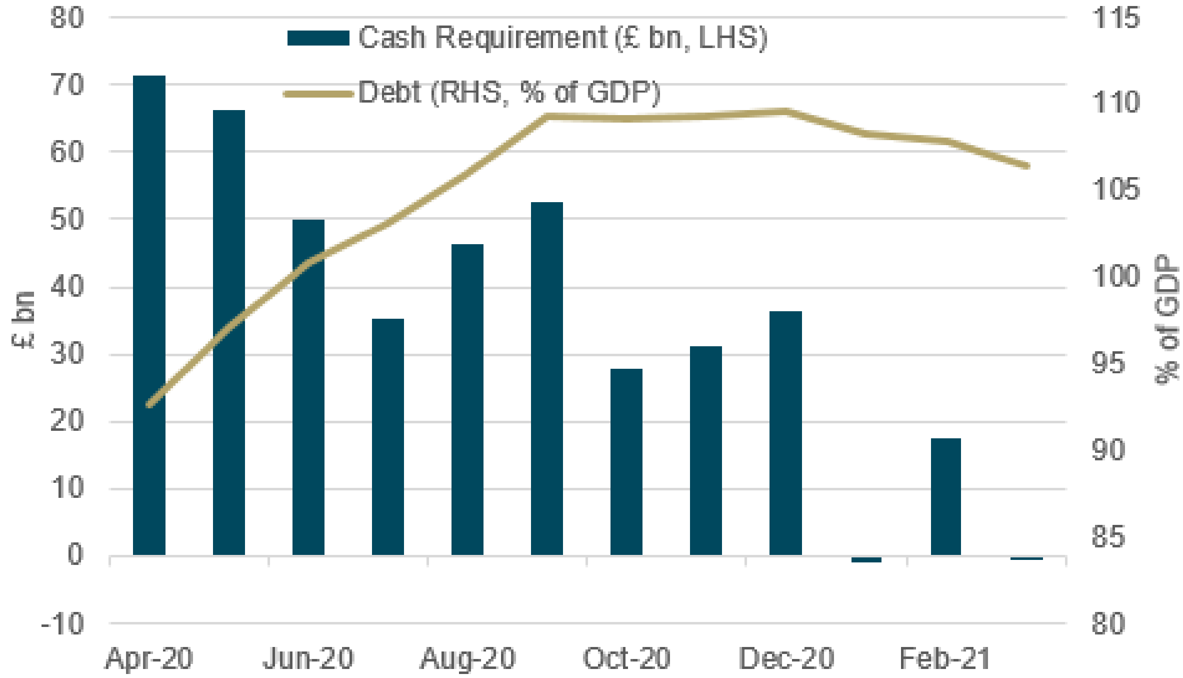
Source: Bloomberg, BNY Mellon

Even if the BoE wants to take the long view and not stand in the way of inevitable economic vicissitudes, we still question whether such a stance is consistent with their price stability mandate. For example, Haldane also noted that the BoE’s job is to "make that process of adjustment as seamless and painless" as possible. From a policy perspective, this means using measures such as quantitative easing to amplify government firepower.

During a reflation phase, such support can certainly strengthen price trends, but the UK is not in that phase. Arguably with the new restrictions coming through, the risk is that the disinflation phase will become extended and as things stand, neither the BoE nor the government have announced measures to offset. Fears of persistently elevated debt levels have clearly affected the government’s decision making, but barring a renewed full lockdown of the economy, the bulk of fiscal stress has likely passed.

The latest Office of Budget Responsibility (OBR) forecasts published in August sees a stabilization in the debt outlook and the public sector net cash requirement will likely fall into surplus towards Q1 next year. This still leaves the debt/GDP ratio peaking at close to 110% (see chart below) but at least within G10, the market is hardly looking at debt sustainability issues while COVID-19 continues to damage economies.

OBR Debt Projections (Aug 2020)



Source: OBR, BNY Mellon

More immediately, the news that the Autumn Budget may be delayed represents a new challenge for the BoE as they will need to decide on policy with limited visibility on future fiscal policy. After all, these are the very policies which should intend to – to quote Dr Haldane – "adjust" the economy and replace the jobs which are not coming back.

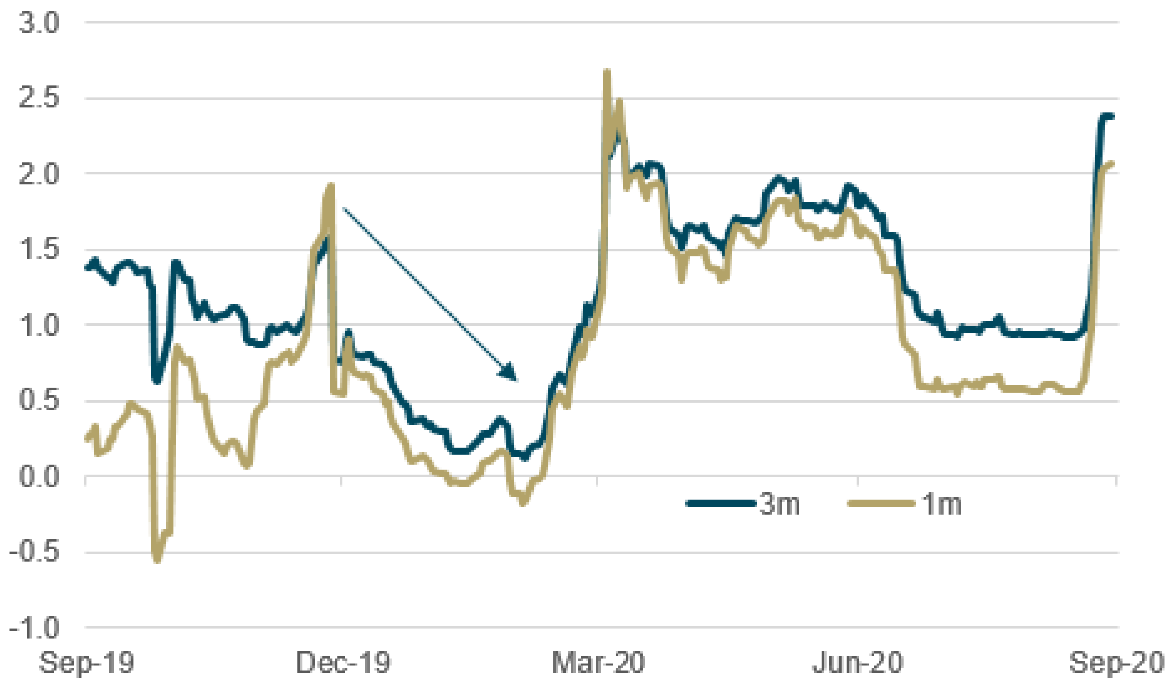
In normal times monetary policy would act in a complementary manner, but the BoE may now have to wait a bit longer. Constitutionally, the UK is required at the bare minimum to pass a budget resolution before the end of the financial year in April 2021. It is highly unlikely that the government will leave it so late but on top of economic challenges and the Brexit impasse, the additional uncertainty is hardly welcome.

> ***We still question whether [the BoE's stance] is consistent with their price stability mandate***

Sterling has moved materially lower from summer highs but almost exclusively on the back of Brexit developments.

The recent jump in EURGBP risk-reversals is similar to the cross’ pathway as the UK negotiated its outright EU exit towards the end of last year. The Internal Markets Bill – the center of contention with the EU – will be moving its way through the House of Commons this week and it remains to be seen whether any amendments to the EU’s satisfaction can be realized by month-end.

EURGBP 25d Risk Reversals



Source: Bloomberg, BNY Mellon

> ***Sterling price action will lean much more on domestic economic and fiscal matters over the coming months***

A lack of a trade deal after the Brexit transition period is complete will certainly change the BoE's conditional assumptions on monetary policy. However, the November meeting is probably the first in which there is any prospect of a corresponding change and the BoE will be treading carefully on this matter so as to not preempt the government on a political issue.

As a result, sterling price action will lean much more on domestic economic and fiscal matters over the coming months. If so, even if a UK-Brussels deal is struck after a (virtual) walk in the woods between key leaders, we would not expect any let up in the currency's volatility as growth risks come to the fore.

Please direct questions or comments to:

AerialView@BNYMellon.com

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