Economics

NatWest

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UK Economics

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BoE Policy Monitor

Taper over the cracks; pay 2y1y SONIA

With economic activity data coming in above the Bank's February *Monetary Policy Report* forecasts, a sizeable downward revision to the UK Government's borrowing remit and tapering action by the Bank of Canada, we expect the BoE to reduce its QE purchase pace from~£18bn a month to ~£14.5bn with the announced buybacks concluding around mid-December.

We expect the BoE to leave monetary policy settings unaltered in May (Bank Rate at 0.10%, total QE purchase target at £895bn), with unanimous policy votes.

Whilst any tapering announcement may be taken by the markets as a harbinger of earlier monetary policy tightening, the UK's medium-term economic and fiscal fault-lines remain all too apparent. Although we expect a decisive 'hawkish' shift in the MPC's formal policy guidance before the end of this year – in the context of pent-up consumer demand and (temporarily) above-target inflation – we do not expect Bank Rate rises until well into 2023.

We look for upward revisions to the MPC's GDP and CPI inflation projections (Table 3, p.4). For the CPI central projection, we forecast ~5bp increases at the policy-relevant 2-year (2.05%) and 3-year horizons (2.15%) – a reinforcement of the policy signal that prevailing market rate expectations err on the low side.

<u>Rates trades:</u> Pay 2y1y SONIA targeting 0.55% due to an upbeat BoE and increase risk in short 10y gilts, targeting 1%. Tapering in May is widely expected and back-end steepeners are too consensus so avoid them. Higher net DV01 could steepen the curve but this may not happen right after the May meeting.

Table 1: NWM sterling interest rate forecasts, %

	Current	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23
BoE Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3m SONIA	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
5y SONIA swap	0.44	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55
10y gilts	0.77	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
30y gilts	1.30	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50

Source: NWM

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Slowing the pace of QE purchases

As was the case in February 2021, the main focus ahead of the BoE's *Monetary Policy Report (MPR)* in May is on whether the MPC opts to slow the QE purchase pace.

Were the MPC to continue to make QE gilt purchases at the current pace, November 2020's £150bn uplift would be completed by the autumn. It seems more likely that the MPC will want to slow the purchase pace to stretch these QE operations out to around year end. A more gradual slowdown in QE purchases would tend to lessen any disruption in markets than a more abrupt halt, while also making it easier to announce further purchases around the turn of the year should further monetary support be required.

Gilt supply is expected to remain substantial in the current year (we forecast the fiscal deficit to be ~10% of GDP, ~£220bn), Such quantities of issuance have never been funded in the absence of parallel central bank QE purchases (Chart 1). Empirically, BoE QE gilt purchases have tended to coincide with periods of sizeable government borrowing/gilt issuance. As Chart 1 shows, expected Central Government Net Cash Requirement (CGNCR) borrowing in 2021-22 FY (~£220bn on our forecast) greatly exceeds the remaining ~£100bn of QE gilt purchases announced in November 2020. Hence we maintain our forecast for an additional +£50bn of QE gilt purchases to be announced in Q1 2022. Table 2 (p.3) provides a numerical summary of the expected pace of QE purchases.

Chart 1: UK Government borrowing & BoE QE, £bn

Source: OBR, BoE, NWM

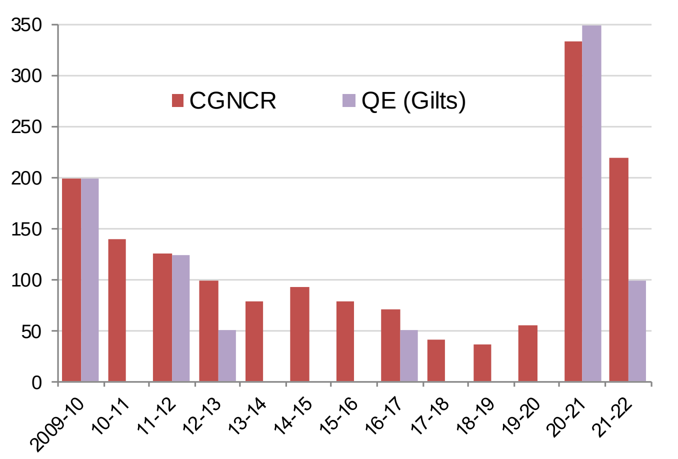
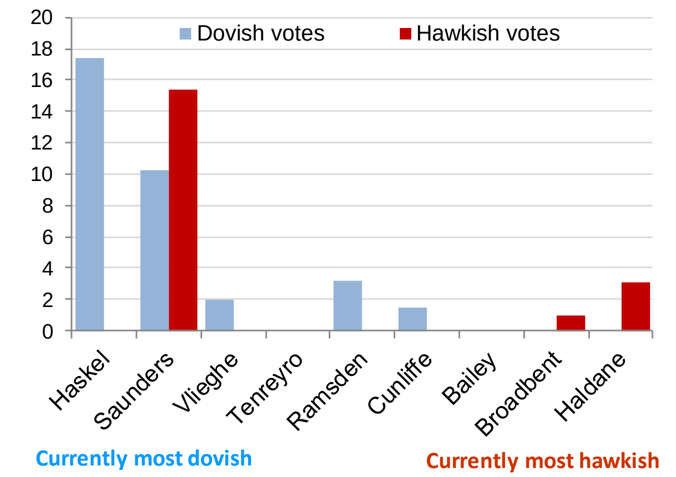


Chart 2: MPC dissent (% of meetings with dissenting vote)

Source: BoE, NWM



We attach very low probabilities to dissenting votes within the MPC on the main policy settings in May: 0.10% Bank Rate and a QE asset purchase target of £895bn (£875bn of gilts, £20bn of corporate bonds). Unanimity has prevailed at each of the previous six meetings – the last dissenting vote being Andy Haldane's 'hawkish' opposition to the £100bn QE uplift in June 2020.

Chart 2 illustrates MPC members' historic voting records. The bars record the % of times dissenting votes from the majority have been cast by individual MPC members and in which direction (eg, Michael Saunders is the only current MPC member to have dissented in both 'hawkish' and 'dovish' directions). The ordering of MPC members on the x-axis is our subjective view of policymakers' current disposition: from most dovish on the left (Haskel) to most hawkish on the right (Haldane).

Expected QE purchase schedule

Table 2 shows our estimates for the stock of gilt and corporate bond QE in the coming months. The numbers reflect our expectations for a slower QE purchase pace from the current £4.44bn to £3.60bn weekly, a £50bn increase in the stock of QE at the February 2022 MPC meeting together with scheduled bond redemptions (June 2021, September 2021, March 2022, July 2022 and September 2022).

Table 2: BoE QE purchase totals, actual & NWM forecast, £bn

End-period totals, Source: NWM, BoE

	Gilts	Corporate bonds	Total QE
Pre-crisis baseline	*435*	*10*	*445*
January 2021	734	20	754
February 2021	753	20	773
March 2021	774	20	794
April 2021	791	20	811
May 2021	807	20	827
June 2021	**806**	**20**	**826**
July 2021	822	20	842
August 2021	836	20	856
September 2021	**835**	**20**	**855**
October 2021	852	20	872
November 2021	867	20	887
December 2021	875	20	895
January 2022	875	20	895
February 2022	888	20	908
March 2022	**875**	**20**	**895**
April 2022	887	20	907
May 2022	900	20	920
June 2022	912	20	932
July 2022	915	20	935
August 2022	925	20	945
September 2022	**925**	**20**	**945**
October 2022	925	20	945
November 2022	925	20	945
December 2022	**925**	**20**	**945**
Change vs baseline	***490***	***10***	***500***

May 2021 *Monetary Policy Report (MPR)* forecasts

We expect only modest revisions to the MPC's key macroeconomic forecasts in the May *Monetary Policy Report (MPR)*, primarily as a result of a less acute decline in GDP in Q1 2021 (a fall of around 2% q/q vs the February *MPR* projection of -4.2% q/q). Because much of this upward revision to Q1 will probably be regarded as simply bringing forward some of the expected recovery in 2021 (as opposed to revising up the pace of expected growth over the medium term), it is not expected to bring about a significantly different recovery profile.

Still, modest upward revisions to GDP in 2021 (~6% from 5.1%) and a broadly unrevised outlook in subsequent years will probably nudge the CPI projections slightly higher. Higher market rate expectations (~15bp higher in Year 1, ~20bp in Year 2) will dampen any increase in projected inflation at the policy-relevant 2- and 3-year horizons – we look for upward revisions of ~5bp to CPI inflation forecasts (Table 3).

Table 3: NWM expectations for BoE forecasts in May 2021 *MPR*, %		
	February 2021	**May 2021**
CPI inflation, 2-yr point	2.11	2.15
CPI inflation, 3-yr point	1.98	2.05
GDP, 2021	5.1	6.1
GDP, 2022	7.2	6.8
GDP, 2023	1.3	1.3

The March 2021 MPC Minutes concluded that overall financial conditions were 'broadly unchanged'. This might seem a little surprising given the surge in bond yields. However, the BoE's *Monetary & Financial Conditions Index* (MFCI) has a heavy equity weighting (rising equity prices represent a loosening – with further gains since February 2021) while the interest rate component is a combination of shorter-term rates (which have risen less than longer-dated rates) and mortgage spreads where changes have been relatively small in recent months (Chart 3).

Chart 3: BoE Monetary & Financial Conditions index

Source: BoE

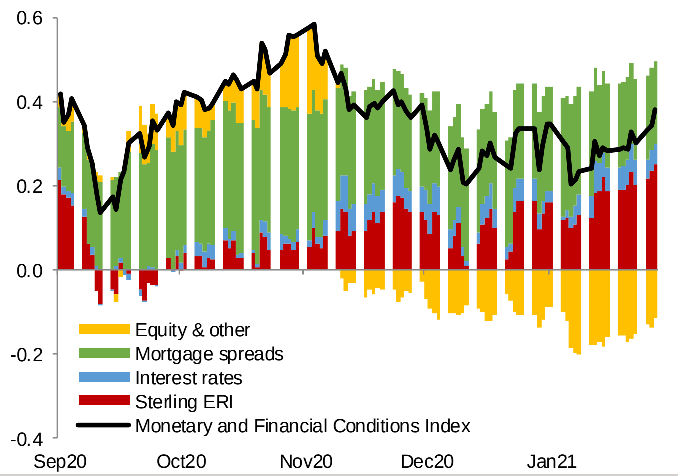
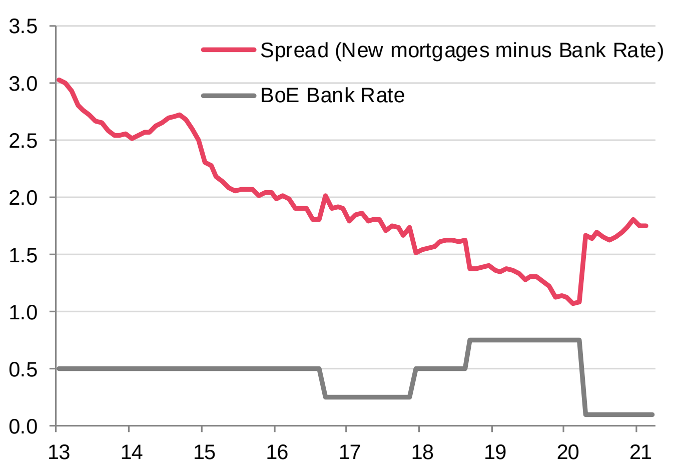


Chart 4: BoE Bank Rate & mortgage rate spread

Source: BoE, NWM



Economic data developments

CPI inflation averaged 0.61% (y/y) in Q1 2021, below the February 2021 *MPR* forecast of 0.82%. The monthly CPI data have been quite volatile around the turn of the year as Covid-19 restrictions have disrupted economic activity and seasonal pricing patterns. The latest CPI data (for March 2021) brought some underlying 'mean-reversion'. There is additional uncertainty around the Q2 2021 data reflecting large swings in energy prices and the impact of the re-opening of the economy. The February *MPR* forecast was for CPI inflation to average 1.57% in Q2 (very close to our own forecast at 1.55%) and 1.46% in Q3 (below our 1.95% forecast). NB, the March 2021 Budget brought some alterations – eg, the extension of the VAT cut for the hospitality sector.

GDP data suggest a better-than-expected outturn in Q1 2021. The contraction in January (revised up to -2.2% m/m) followed by modest growth in February (+0.4%) and with survey data signalling an acceleration in growth in March suggest GDP will fall in Q1 by just 1½%-2% q/q, vs the February *MPR* forecast of -4.2%. Whilst some of the upside surprise in Q1 may simply represent a displacement from the MPC's distinctly buoyant Q2 2021 forecast (+5.2%), the risks appear to be tilted clearly towards upward revisions to the BoE's GDP forecasts in 2021. We look for the MPC to revise up their 2021 calendar-year GDP forecast by ~1% point to 6.1% (Chart 5 shows the expected % q/q profile for GDP).

Chart 5: BoE GDP forecasts, % q/q

Source: BoE, NWM

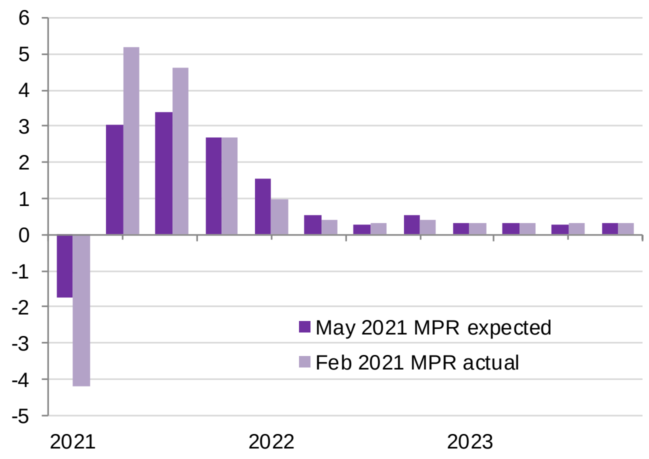
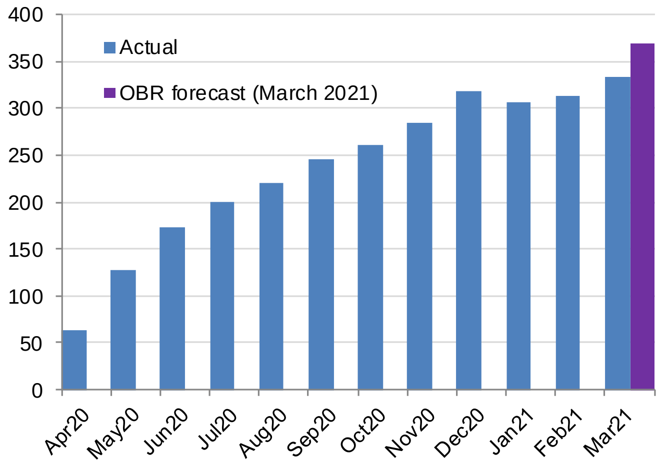


Chart 6: CGNCR borrowing, cumulative 2020-21 FY, £bn

Source: ONS, NWM



The UK **public finances** reported a larger-than-expected *under*shoot in 2020-21 FY borrowing (undershoots in borrowing have been something of a rarity over the past year). The *Central Government Net Cash Requirement (CGNCR)* – the borrowing aggregate which underpins Gilt issuance – totalled £334.5bn in 2020-21 FY, some £35.2bn below official (OBR) forecasts (£369.7bn) (Chart 6). Borrowing is still at historically-high levels (~16% of GDP), and will remain elevated for several years (we forecast ~10% of GDP in 2021-22 FY), but the undershoot vs OBR forecasts which emerged in the latter part of the financial year is notable, resulting in a £41bn revision to the DMO remit.

Lower borrowing outturns lessen the risks of an adverse market reaction to any slowdown in the QE gilt purchase pace announced in May – though as noted above, the medium-term outlook for supply is substantial and we are far from convinced that this supply can be digested by markets close to prevailing yields (~0.75% on 10-year gilts). Hence, a further uplift in the QE purchase target may still be required – we maintain our forecast for +£50bn in Q1 2022.

The **UK labour market** has continued to demonstrate resilience, most notably increases in PAYE employee numbers in 3 out of the past 4 months. The Labour Force Survey (LFS) unemployment rate outturns have, thus far, been running some way below the February *MPR* forecasts: 4.9% in the 3 months to February 2021 vs the MPR projection of 5.5%. NB, the February *MPR* projections were put together before the March 2021 Budget extension of the furlough scheme was confirmed.

UK **retail sales** data staged some recovery in February and March after a distinctly weak period around the turn of the year. These are volatile data at the best of times but the partial recovery seen in 2021 (sales volume levels are less than 2% below end-2020 levels) helps to shore-up confidence about consumer demand over the next 6 months or so.

Money & credit data remain generally buoyant, with the Q1 lockdown resulting in a further build-up of money holdings. Lending to the corporate sector staged a partial recovery in February (latest data), under-pinned by both bank lending and capital market activity, suggesting that – in aggregate – the corporate sector continues to have access to adequate levels of affordable funding.

BoE policymaker comments

MPC policymaker communications have been limited since the 18th March policy meeting. There has been scant evidence of MPC concerns about rising market rates, with **Governor Andrew Bailey** stating that the move higher is *'consistent with the change in the economic outlook.'* (BBC Radio 4, 15 March 2021).

Chief Economist Andy Haldane sounds ever more bullish, though remains something of an outlier. Mr Haldane told ITV News: *'If some of those savings get spent, even a small amount of them, we're talking about a pretty rip roaring recovery. When it comes, it will come fast and it will be large.'* (24 March 2021).

On the 'dovish' wing of the MPC, Messrs Vlieghe and Haskel have continued to sound a cautious note about the medium-term outlook. Jan Vlieghe remains fundamentally dovish: *'To my mind, seeing some strength this year, which I do expect, is not going to be nearly enough to then conclude this is an economy that doesn't need monetary help anymore.'* (29 March 2021). Jonathan Haskel stated *'I see relatively little risk of sustained above-target inflation'* (5 March 2021).

In terms of key-note speeches, Silvana Tenreyro commented: 'Despite lessening downside risks, there also remain a number of scenarios that I would anticipate requiring looser policy later this year.' (26 March 2021).

Michael Saunders, a recent dovish dissenter but probably best viewed as the MPC member most inclined towards an 'activist' monetary policy, argued in a recent speech that larger amounts of spare capacity in the economy may allow faster growth without fuelling a sustained breach of the inflation target. In term of timing*: 'for the output gap to close sustainably and return inflation to target on a sustained basis, activity needs to close the shortfall with post-pandemic potential output. In my view, the* MPR *forecast for unemployment three years ahead (4½%) is likely to be a useful benchmark in judging the extent to which this has been achieved.'* Mr Saunders argued that the MPC's unemployment rate forecast of 5.7% in Q1 2022 *'would almost certainly indicate that we are some way from closing the output gap sustainably'* – thereby suggesting little near-term pressure for early monetary policy tightening.

Rates implications – pay 2y1y SONIA

At the May meeting, the BoE is likely to strike an upbeat tone both verbally and through more optimistic forecasts. With that in mind we want to run **bearish rates** positions into the meeting. Chart 7 shows moves across SONIA forwards since the previous BoE meeting. We can see that rates have broadly fallen with the curve bowing in. In our view this is **an opportunity to initiate shorts** and in this piece we will explore different options.

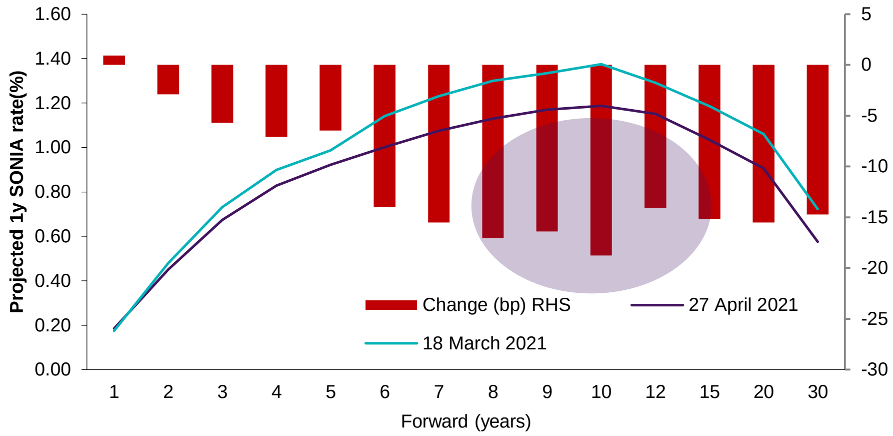
1. **Short 2y1y SONIA – our favourite trade into the BoE meeting:**

   Upward revisions in GDP and inflation data will trigger a discussion on the timing and magnitude of the next hike. While we do **not** expect any hike before 2023 (see Table 1), the next hike does not have to be in 25bp increments, ie we can envision a move up straight to 0.5% at some point in 2023. Moreover, we believe that risks are skewed to any hikes being brought forward or take place at a faster pace and Broadbent's recent comments support the optimistic BoE camp. This position is an amalgamation of a "bearish rates" and a "steeper money market" views.

Pay 2y1y SONIA: initiate at 0.458%, target 0.55%, stop loss 0.4%

Chart 7: Forward changes since the Mar'21 BoE meeting

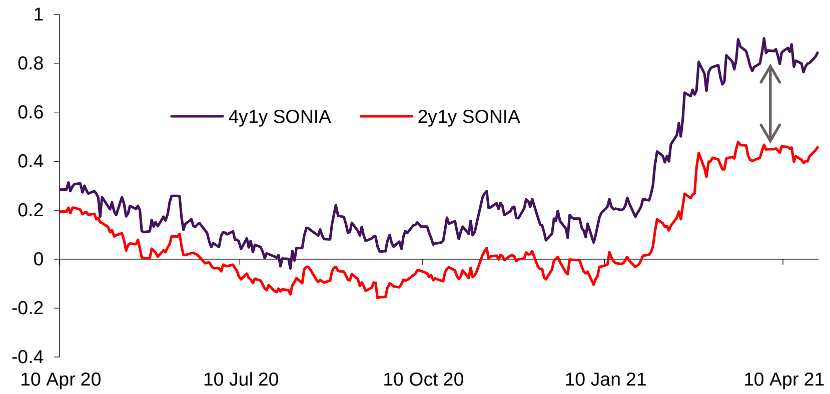
Source: NWM, UK DMO



Once QE tapering moves to the rear-mirror, the market will discuss the **sequencing of tightening** and in our view it is easier to hike rates than reduce the size of the balance sheet (similar to BoE's behaviour in 2017 and 2018). Chart 8 compares the evolution of 2y1y and 4y1y forwards. We believe that there is more upside potential in the 2y1y forward relative to longer points on the curve hence this is our short of choice. NB we have been short 5y SONIA here and here and closed the trade here.

Chart 8: The front-end offers attractive level for shorts

Source: NWM, UK DMO



2. **Short 10y gilts –run short at full risk:** This is a structural position and in the piece 10y gilts to1% we extended the short position albeit at half the risk as we felt that the bearish view became too consensus. Following the clean-up in positioning on 7-9 April, we believe that **the short camp is less crowded** while macro data have been resilient. Therefore we increase our conviction to the short 10y trade (ie run at normal instead of 50% risk).

3. **Back-end steepeners – not great**: The probably **most consensus** view in the gilt market is that the BoE will taper at the upcoming meeting and hence the curve should steepen. We are **reluctant** to enter into back end steepeners (say 10s30s) for the following reasons: A) What happens is the BoE does **not** taper at the upcoming meeting? This is a low-probability event but it will be a significant shock for the market and tactical steepeners will rush to be unwound. B) When an event is widely expected, and the majority of investors have positioned for it, then it will struggle to perform even if it happens.