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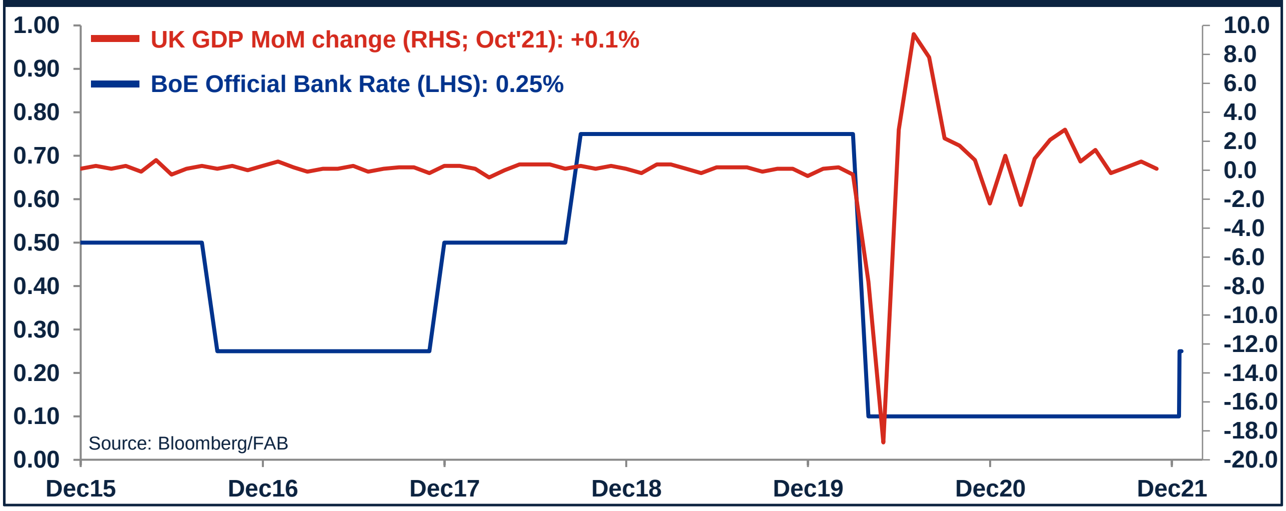
FAB Macro Strategy: BoE's policy mistake

- **We knew the BoE could go soon, but this was 'too soon'**
- **Inflation, the sole basis for tightening, may yet prove transitory**
- **Raising rates amid parlous Covid-19 infection rates is a dangerous strategy**
- **PMI data also paints a more sobering macro picture**

Our regular readers will recall that we had stated previously that we thought that the Bank of England could be the first of the major (G10) banks to increase interest rates. That said, while we thought they could go 'soon', we certainly didn't expect them to go this soon and saw little justification for such hawkish action last week. Of course, the move by the BoE came as part of a hawkish trilogy with the Fed and the ECB also both showing a tighter bias in their policy rhetoric last week – although, importantly, the latter two have kept rates firmly anchored for now.

This was 'too soon' from BOE



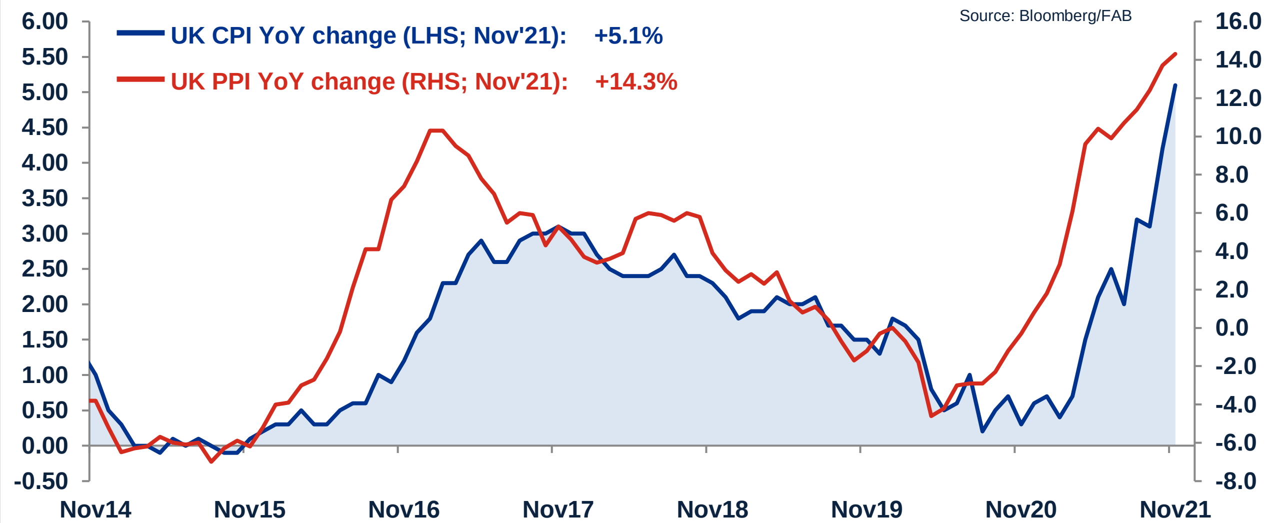
Notwithstanding all the confusion at the time of the Bank's November MPC meeting, when the market was subliminally told to brace for a rate hike, only for the BoE to then 'disappoint' and fail to deliver, we still believe that last week's (token 15bps) rate increase in the Bank Rate to 0.25% will soon prove to have been a policy mistake. Here's why.

Their sole justification for tightening

The Bank of England's sole, but still very understandable, basis for increasing rates last week appears to have been inflationary pressure. With CPI running at 5.1% YoY in November – way above the official 2% target - and seemingly set to edge higher still in Q1 2022, we can see why the Monetary Policy Committee was keen to hit the button marked 'hike'. But we continue to believe that is too blinkered, short-term a view of inflation, which over the coming months we do expect to prove itself as somewhat transitory.

As discussed previously, we see inflation falling back quickly in 2H2022, after peaking in late Q1 or early Q2. The MPC now sees the high point at around 6%, close to our anticipated peak of just sub-6%. Looking beyond such an early 2022 peak, if energy prices follow a similar path to the futures curve, inflation could in fact be back below target as early as 2023.

Inflation drove BoE action, but price pressures may yet prove transitory



In this scenario, last week's rate increase could be perceived as a premature policy mistake. At the very least is should be seen as a 'one and done' strategy for putting some token ammunition back in the monetary policy chamber.

But there are arguably many more reasons not to hike

Given the parlous state of the U.K. in terms of current Covid-19 infection rates and the escalating spread of the Omicron variant, we were more than surprised when the Bank of England raised rates last week. If anything, we would have expected the uncertainties surrounding and the opaque veil cast across the Omicron pathogen to have persuaded the BoE to keep its powder dry for now. With UK economic sentiment under increasing downward pressure once again and with rising concerns about potential new socio-economic lockdown restrictions being introduced by the BoJo government before Christmas, we would conjecture that caution should remain the better part of valour for now.

Admittedly, if virus infection rates begin to recede, then the BoE may be able to argue that last week's tightening move was justified; they may just get away with it. But for now the reality is that infection rates are rising exponentially , not receding, and the economy is losing steam as consumers become more cautious. Moreover, alluded to above, we are cognizant that there is a not insignificant risk of new socio-economic restrictions being put in place over the coming week(s). Under that scenario, the rate rise would surely look like a policy mistake.

Raising rates now is a huge risk, in our view, given the impact that any near-term restrictions would surely have on consumer sentiment and the economy in general. All eyes need to remain firmly fixed on the government's Plan B anti-Covid restrictions, not to mention the spectre of Plan C in response to the omicron variant.

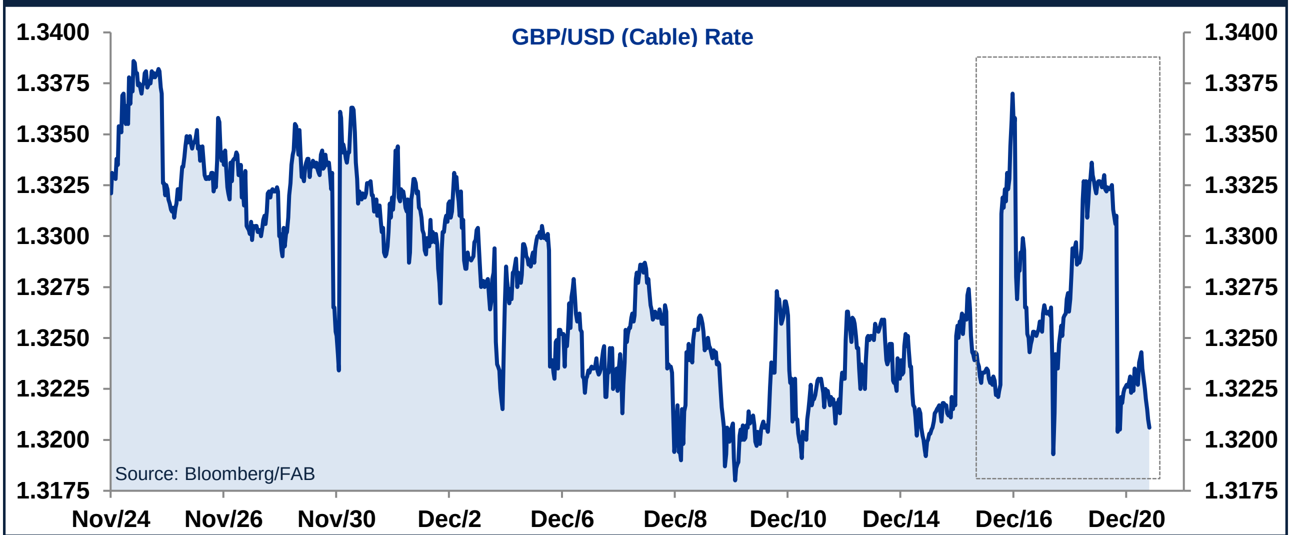
Aside from the current ominous Omicron data, we would also suggest that myriad other recent macro data releases would corroborate a more dovish stance for U.K. monetary policy. Indeed earlier this month, October GDP figures showed a much slower-than-expected rate of recovery for the U.K. economy, coming in at just +0.1% MoM, down from +0.6% in September and below consensus (+0.4%). Meanwhile U.K. industrial production data for October painted a picture of deepening contractionary conditions. October IP fell to -0.6% MoM in October from -0.4% in the prior month. Consensus had been for a rebound to expansionary territory (+0.1%).

But it is the latest U.K. PMI data – released just last week – that makes the BoE rate increase look even more surprising and potentially a policy mistake. The Markit UK PMI Manufacturing index may have only slipped modestly – to 57.6 this month from 58.1 in November – but the Services PMI index was a lot more sobering. Markit Services PMI declined sharply to 53.2 this month from 58.5 in November with the market having only been expecting a softening to around the 57.0 level. And this, well before any new Covid/Omicron restrictions come into force.

Bottom line

We are hopeful that the BoE will see last week's rate move in the context of a 'one and done' strategy for now. The persistently worrying uncertainties surrounding Covid-19 and the Omicron variant – even if they hopefully begin to recede from a peak early next year – certainly seem to warrant such an approach.

Cable gyrations seem to reflect a 'one and done' strategy from BoE



Indeed, given the gyrations in Cable (GBPUSD) over the past week, the market does seem to be sympathetic to our view. Sterling rallied on Thursday in the wake of the rate increase, from $1.3259 to a session high of $1.3374, but has subsequently failed to hold onto those gains. As a result, GBP has consolidated lower since Thursday and was seen in the context of $1.3205 at the time of writing (12.55pm GST 20/12/21)

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