Private Bank

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ECB and BoE: donning a more hawkish mantle

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BANK OF ENGLAND (BOE) AND EUROPEAN CENTRAL BANK (ECB) MEETING SUMMARY:

- **At its meeting today, the Bank of England (BoE) raised Bank Rate by 25 basis points (bps) to 0.50%**
- **Four members of the BoE Monetary Policy Committee dissented, voting for a 50bp rate hike**
- **UK assets prices were under pressure also reacting to some tapering of the BoE balance sheet**
- **At its meeting today, the European Central Bank (ECB) left all its key interest rates unchanged**
- **There were no changes to any of the guidance, either with respect to interest rates, or asset purchases (including reinvestments)**
- **President Lagarde acknowledged discomfort about the size and length of the inflation overshoot**
- **Euro area assets sold off, with the Germany-Italy 10y sovereign bond spread up to a 16-month high**

BANK OF ENGLAND (BOE) HIKES FOR THE SECOND CONSECUTIVE MEETING

Key announcements – The Bank of England (BoE) increased its Bank Rate by 25 basis points (bps) to 0.5% as widely expected by investors. The Monetary Policy Committee (MPC) voted 5-4 in favour of a 25bps hike. The four members in the minority (Haskell., Mann, Ramsden and Saunders) voted in favour of a 50bps hike. Regarding assets held on the BoE's balance sheet, the MPC voted unanimously to start reducing the stock of UK government bonds by ceasing to reinvest maturing assets. The same decision was taken for the stock of sterling non-financial investment grade corporate bonds. However, rather than the passive approach that applies to UK gilts, the MPC opted for an active tapering strategy, planning to unwind fully the stock of corporate bond purchases that it holds "*no earlier than towards the end of 2023"*. This was a hawkish surprise.

Bank Rate the primary policy toll – Note however that beyond the benefit of having flexibility about which instruments to use, the MPC reaffirmed its preference in most circumstances to use Bank Rate as its active policy tool when adjusting the stance of monetary policy.

Faster to 1% Bank Rate – The monetary policy summary also introduced some change of guidance, implying a slightly higher degree of urgency about the adjustment of the monetary policy stance. The MPC tweaked the message slightly but significantly with respect to the time horizon of likely policy actions. On the basis that the economy continues to develop along the lines of the MPR, the MPC continues to point to some further "*modest*" tightening in monetary policy "*in the coming months*", rather than "*over the forecast period*" reference used in December.

Forecast changes – The direction of travel was lower for GDP growth, which is expected to slow from 7.8% YY (-2.3pp) in 1Q-22 to 1.8% YY (-0.3pp) in 1Q-23, to 1.1% (-0.1pp) YY in 1Q-24 and to 0.9% YY in 1Q-25. While a deceleration is also expected for inflation, the scale of upward revisions was sizeable without changing the 2-year period during which CPI is anticipated to remain above the BoE's target. CPI inflation is expected to moderate from 5.7% YY (+1.1pp) in 1Q-22 to 5.2% YY (+1.9pp) in 1Q-23, 2.1% YY (unchanged) in 1Q-24 and 1.6% YY in 1Q-25. At the end of the forecast period, the MPC expects the unemployment rate to climb to 5% and excess supply to build to around 1%.

Limit to how much Bank Rate can rise to – To be sure, the MPCs' updated central projections for activity and inflation presented in the February Monetary Policy Report are conditioned on a market-implied path for Bank Rate rising to 1.4% in 1Q-24. As a result, today's more hawkish market positioning would at the margin imply a slightly greater tightening financial conditions and would increase the likelihood of some undershooting of the GDP growth and inflation baselines.

Update to BoE rate path – There will be a natural limit to how much tightening the BoE can deliver. At some point, caution will need to be exercised given the persistence of downside risks to growth, partly due to the spike in energy prices, but also the possibility that 100bps of rate hikes in quick succession could dampen household confidence. We now expect the BoE to lift Bank Rate again by 25bps at the 17 March meeting and at the 5 May meeting, extending the series of back-to-back rate hikes to four. At 1%, we think that the BoE will likely pause or at least slowdown the pace of 25bps rate hikes to one per quarter up to a maximum Bank Rate of 1.5% by Nov-22 to see how the economy unfolds.

Market reaction – UK assets were under pressure throughout the day, with the FTSE 100 losing around 0.7% (5pm GMT). Most sectors performed negatively, with largest losses in information technology (-2.9%) and industrials (-2.0%). Unsurprisingly, Energy (+1.2%) and Financials (-0.1%) outperformed. The UK yield curve bear-flattened, with the 2-year gilt yield rising by almost 12 bps to 1.15%, while the 10-year gilt year climbed by 11bps to 1.37%. GBP/USD rose a little, up 0.2% to 1.36 while GBP/EUR fell noticeably, down 0.9% to around 1.1905.

MARKET OUTLOOK

For a summary of our latest views, please see our EMEA Bulletin (February 1).

We continue to see upside potential from the UK financial sector amid a rising interest rate environment. The UK financial sector remains cheap, and earnings momentum positive while upward pressure on rates should contribute to higher net interest margins and profitability. The positive continued momentum of declining provisions, as well as increasing fee income from trading and M&A activity, could drive stronger earnings for the next 12 to 18 months for the sector.

We remain underweight UK government bonds amid strong evidence that the BoE will engage in balance sheet reduction which will require the private sector to shoulder a greater share government borrowing, most likely at higher nominal yields.

ECB OPENS THE DOOR TO A RATE HIKE IN 2022 BUT STEADFAST ABOUT SEQUENCING

All key rates and guidance unchanged – The European Central Bank left all its key interest rates unchanged. The forward guidance was the same as in December. The Governing Council (GC) expects the key interest rates to remain at their present or lower levels until its sees inflation **(i)** reaching 2% well ahead of the end of its projection horizon, **(ii)** and durably for the rest of the projection horizon, and **(iii)** it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term.

Size and length of overshoot causing some discomfort – While the full ECB guidance also includes a reference to the fact that "*this may also imply a transitory period in which inflation is moderately above target*", the tone of today's press conference suggests that not only the likely size of the overshoot but also perhaps its duration could lead to an intense debate during the spring about how best to wind down the net asset purchase programme to respect the sequencing which stipulates that rate hikes can only happen after the net asset purchases

Guidance change coming in March – ECB President Christine Lagarde indicated during the Q&A session that there was a "*general consensus about today's decision*", implying that some GC members probably would have preferred some adjustment to the interest rate guidance, probably about the possibility of lower rates, but also about the open-endedness of the APP.

Economic assessment broadly unchanged – The GC acknowledged that inflation was surprising to the upside and that after a difficult first quarter, the euro area economy should recover and will likely be less hurt by the pandemic, on account of easing supply bottlenecks but also a likely continued tightening in the labour market, paving the way for a strong rebound in domestic demand during the course of 2022, helping GDP growth expand by around 4.2% in 2022 and 2.9% in 2023 after a 5.1% increase in 2021. Risks to the economic outlook were judged once again to be "*broadly balanced over the medium term*".

Reading between the lines – As is often the case, we could glean more information about what was not said by President Lagarde. Despite being asked many times what she thought about the market pricing of a first ECB rate hike in 2022 and whether she would repeat her statements of December that "*it is very unlikely that we will raise interest rates in the year 2022*", President Lagarde preferred to focus her communication on the three pillars that must be met for this path to be followed.

Live meetings in March and June? – There were multiple references to the fact that more information would be available in the next forecast rounds of March and June when a 'thorough' assessment would be made. Most likely reflecting the tone of the discussion during the meeting, President Lagarde conceded that inflation is getting "*much closer to the 2%*" symmetric target, but that the ECB would remain data dependent and that it would observe the pre-determined sequence in adjusting policy, while highlighting the need for gradualism.

The right step(s) at the right time – Assuming that inflation mid-points of 1.8% for 2023 and 2024 are revised up to 2% in March and stay there (or rise above it) in June, we suspect that it would be enough for the Governing Council to conclude that the time has come to formalize the end of asset purchases. We would expect the ECB to proceed in stages. We think it is very likely that the bias to ease policy rates will be removed in March and that the GC end asset purchases by the end of the year instead of the current guidance that it will maintain net asset purchases under the APP at a monthly pace of 20bn for as long as necessary from October. But if inflation continued to surprise to the upside in June or in the event of a very sizeable upward revision to inflation in March, the GC could also announce a quicker taper and an end of net asset purchase in 3Q-22, opening the door to a first hike by December.

Most likely rate path – There is no rush for the ECB to hike interest rates before the end of 2022. For too many years inflation has undershot its target and there are some risks associated with the suspension of the pandemic emergency purchase programme (PEPP) in March, particularly for some sovereign spreads which could impede the transmission of the monetary policy stance in some jurisdictions. Market pricing of up to 40bps of rates hikes by December looks excessive to us. At the same time, risks of stronger-than-expected GDP growth and higher-than-expected inflation would offer the ECB a golden opportunity to take a step towards ending the policy of negative interest rates which has been in place since June 2014. Our baseline is that a shift in communication will start in March and will likely be reinforced in June, allowing for a first hike of 25bp in the deposit facility rate at the 15 December meeting, to be followed by similar

moves every six months until it reaches 0.75% in Dec-24. This would likely imply a main refinancing rate of 1.25% and a marginal lending rate of 1.75%.

Market reaction – Markets reacted negatively to the change of tone from the ECB. The euro gained as much as 1.5% against the yen to 131.3, 1.1% against the US dollar to 1.1430 and 0.85% against sterling. At 16:50 GMT, the Euro Stoxx 50 was losing 1.9%. The fixed income market repriced aggressively, with the 2y Bund yield up 13bps to -0.33%, the 5y Bund yield up 14bps to -0.04% and the 10y Bund yield up 11bps to 0.15%. The 10y Germany versus Italy government bond spread widened by 11bps to 150bps, its highest level since Sep-20. From an inflation standpoint, the 5Y5Y swap was falling by 6bps to 1.79%, its lowest level since Oct-21.