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08 may 2024

BoE preview: is a shift in policy on the horizon?

PRIVATE BANKING

Executive Summary:

- The Bank of England (BoE) will announce its latest policy decision this Thursday, with markets expecting interest rates to remain at 5.25%. Inflation is gradually improving, but mixed economic signals and potential rate cuts as early as August are keeping investors alert. Services are rebounding, but manufacturing is cooling, and unemployment is rising.
- UK government bonds have faced "bear steepening," where long-term yields have risen faster than short-term ones. The 2-year UK yield is up 40 bps to 4.4%, and the 10-year yield has risen 70 bps to 4.2%, creating the third-worst start in UK bond history.
- How will the BoE navigate these challenges, and what impact will its decisions have on bond markets and the economy for the rest of 2024?

The Bank of England (BoE) is set to release its crucial monetary policy decisions this Thursday, a pivotal event with implications that could reverberate across global markets. While the central bank is widely expected to keep the interest rate at 5.25%, attention will focus on any deviation from potential rate cuts in August, as anticipated by the market. Inflation trends are improving, but economic signals remain mixed: UK weekly earnings are still high (over 5%), the CBI average selling prices over the next three months are sharply rebounding, and the services sector is booming. However, manufacturing is slowing, and unemployment is rising. The previous 8-1 vote to maintain rates could shift to a more divided 7-2, with Swati Dhingra and Dave Ramsden potentially advocating for immediate cuts.

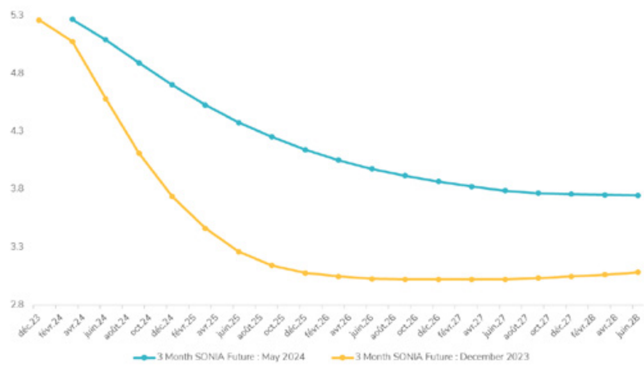
Chart 1: BoE Official Bank Rate (%) vs. UK Inflation Rate (%)

Source: Bloomberg

The BoE's restrictive stance is evident in the above chart, which shows that despite inflation inching closer to the 2% target, the central bank has kept rates high to combat lingering inflationary pressures. This delicate balance will be closely monitored to gauge how well the BoE can manage inflation without stifling growth.

On Thursday, the BoE will also unveil updated economic and policy rate projections. In February, the bank forecast an average rate of 3.75% over the next three years, with four rate cuts anticipated in 2024. But with inflation moving lower and a higher terminal rate expected, will the BoE signal openness to early easing? The market is particularly interested to see if the BoE will hold on to its predictions of 0.25% real GDP growth in 2024 and inflation at 2.75% by the year's end or adjust for a stronger recovery.

Chart 2: Market Expectations for BoE Official Bank Rate: Today (Blue line) vs. December 2023 (Yellow line)



Source: Bloomberg

This chart reveals how dramatically market expectations have shifted over the year. At the start of 2024, the market was pricing in earlier and more aggressive rate cuts, expecting a terminal rate around 3%. Now, market expectations point to a higher terminal rate of 3.75%, reflecting the current economic landscape.

Implications for UK government bond yields

Amid political and economic challenges, markets anticipate two rate cuts in 2024, starting no earlier than August to align with the Federal Reserve. However, if economic indicators suggest it's feasible, the Bank of England could unexpectedly implement an earlier rate cut. Key considerations include the timing of BoE actions relative to the Fed and the approach to policy normalisation.

Political developments are adding another layer of complexity. The Labour Party's strong showing in recent local elections points toward a possible parliamentary majority in the next general election, which could take place in Q4 2024. This shift could lead to new fiscal policies, impacting the BoE's strategy and inflation targets. For now, political analysts believe that improved economic prospects may encourage the government to call the election later in the year when inflation is expected to fall further, and growth will improve.

Due to the prevalence of fixed-rate mortgages, the resulting positive net interest income flows have created a unique challenge for the BoE. Fixed-rate mortgages have supported household finances during the tightening cycle but delayed the transmission of higher rates, boosting annual household savings by GBP 20 billion. As this effect reverses during the easing cycle, the resulting reduction in net interest income could limit the impact of rate cuts, potentially requiring deeper reductions. This dynamic complicates the BoE's efforts to stimulate the economy effectively while managing the bond markets. Given this, investors will closely watch how the BoE balances these dynamics in its upcoming policy decisions.

Chart 3: Yield Differential between 5-year US and UK Yields and USD/GBP Exchange Rate

Source: Bloomberg

The differential between 5-year US and UK yields has remained relatively narrow post-pandemic, fluctuating between 0 and 0.5% except for notable events like the UK government's "mini-budget" crisis on September 2022, which caused an unprecedented surge in UK bond yields.

The combination of volatile bond yields and uncertain monetary policy has led to a challenging environment for investors. UK government bonds are facing their third-worst start in history, with a year-to-date performance of -5% as of April 30th. Indeed, UK government bonds have experienced what's known as a "bear steepening", where long-term yields increase faster than short-term yields.
This has pushed the 2-year UK yield up 40 bps to 4.4%, and the 10-year yield up 70 bps to 4.2%. By comparison, the 10-year US Treasury yield increased by 60 bps to 4.5%, and the 2-year US Treasury yield climbed by 55 bps, while German bonds also saw gains of 50 bps in both 2-year and 10-year maturities.

Chart 4: Total Return of UK Government Bonds over the last four Years

Source: Bloomberg

Furthermore, over the past four years, UK bonds have experienced a significant -31% decline in total returns. This long-term decline reflects the challenges faced by investors and the significant losses incurred. Investors continue to assess the risk of further downside while considering strategic portfolio adjustments.

Conclusion

The Bank of England (BoE) faces a delicate balancing act as it prepares its next policy decision. While inflation trends move closer to the 2% target, economic signals remain mixed, and political uncertainty looms ahead of a possible general election. The Labour Party's recent gains raise expectations of a significant policy shift, potentially influencing the BoE's approach.

The BoE must navigate volatile bond markets marked by "bear steepening," which has resulted in one of the worst starts for UK government bonds in recent history. The timing of potential rate cuts, particularly in relation to the Federal Reserve, will shape the market's expectations and impact investor confidence.

Ultimately, the BoE's response to these challenges will have far-reaching implications. Its ability to signal a clear strategy, balancing inflation control with economic growth, is crucial to stabilizing the economy and steering global markets through the uncertainties of 2024. As investors closely monitor the BoE's communication and policy direction, how will the central bank adapt its strategy to the rapidly evolving economic and political landscape?

For further information

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