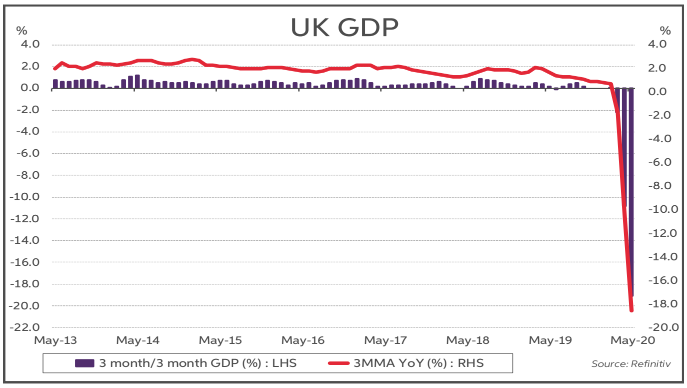
# BoE stays on hold and cool on negative rates

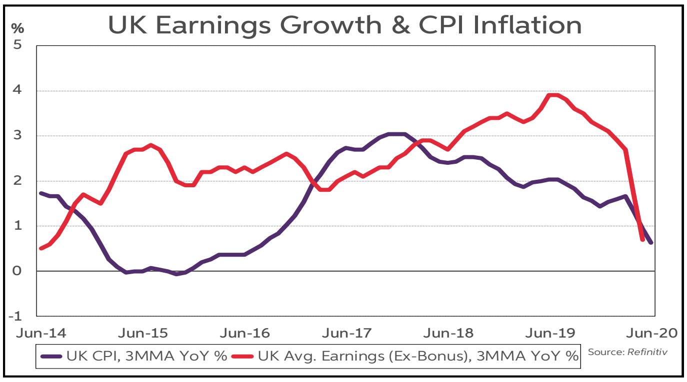



**As anticipated, the Bank of England's August Monetary Policy Committee (MPC) meeting concluded with no changes made to policy.** This decision was unanimous, again in line with market expectations. Today, we also got updated macro forecasts, with the central bank revising upward its 2020 macro projections in the Monetary Policy Report. This largely reflected a revision to the Q2 growth forecast. Overall, the MPC would appear to be signalling that policy will not be eased further in the coming months, barring a deterioration in the outlook, though it is prepared to act if necessary.

**Since the onset of the Covid-19 crisis, the central bank has acted aggressively. This has included cutting the Bank Rate by a total of 65pbs, leaving it at a record low of 0.1%.** In June, the MPC voted to expanded its QE programme by a further £100bn, which will leave the bank's total stock of assets at £745bn by the "turn of the year". Additionally, the BoE moved to provide support directly to businesses through the establishment of a corporate paper purchasing facility and launched a term funding scheme for SMEs.

**The tone of the meeting statement and minutes remained cautious**. The central bank referenced the highly uncertain economic backdrop and again emphasised that the trajectory for growth is ultimately dependent "on the evolution of the pandemic". However, the BoE did note that "recent developments suggest a less weak starting point for the Committee's latest projections". The central bank highlighted the rebound in consumer spending in particular, which has been supported by the government's Job Retention Scheme. It also acknowledged the latest fiscal stimulus efforts from the UK government, which it said have "boosted activity substantially over the forecast period".

**As referenced earlier, the better than anticipated data has prompted the BoE to revised up its forecast for Q2 GDP from –28% to –20%.** In the year as a whole, the MPC now sees output declining by 9.5% against its May forecast for a 14% contraction. The central bank, though, does not envisage GDP returning to pre-crisis levels until end-2021 and is estimating growth of 9% in 2021, which appears optimistic. The projections are based on the assumption of the EU and UK agreeing a comprehensive free trade agreement this year and no second wave to the virus. Given the uncertainty surrounding those assumptions, the central bank highlights its projections are "a less informative guide than usual".




**In relation to the labour market, the BoE emphasised the success of the Job Retention Scheme in preventing mass lay-offs.** While it is assumed most of those furloughed will return to work, some job losses are likely given the scale of the downturn. The unemployment rate is projected to end 2020 at 7.5% compared to circa 4% currently, before declining to 6% by Q4 2021. Meanwhile, the central bank sees headline CPI picking up from 0.25% in Q4 2020 to 1.75% by Q4 2021 and its 2% target in H2 2022, before rising above this level in 2023.

**However, the tweak to the forward guidance in the meeting statement suggests the BoE will be in no rush to raise rates if inflation moves above 2%.** The MPC signalled that it "does not intend to tighten policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably". Indeed, this leaves the door open to further easing should conditions deteriorate, notwithstanding the upward revisions made to the macro projections.

**Although, the central bank appears to be still cool on the possible introduction of negative rates.** In its Monetary Policy Report, it noted that "negative policy rates at this time could be less effective as a tool to stimulate the economy". Instead, it says that it has "other instruments" available, including further QE. Markets, though, still expect the next move by the BoE to be a cut, with circa 10bps of easing priced in by end 2021.

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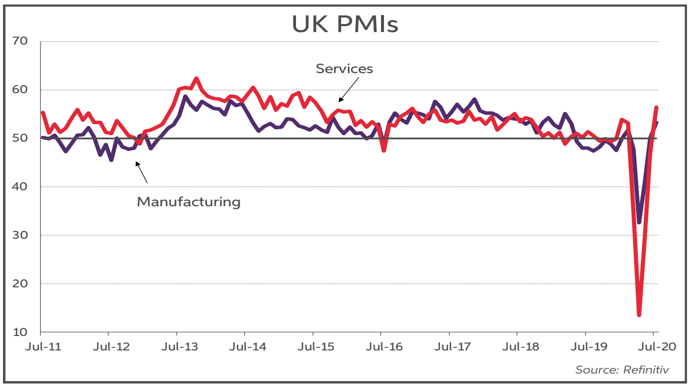
# UK enters deep recession, but signs of recovery

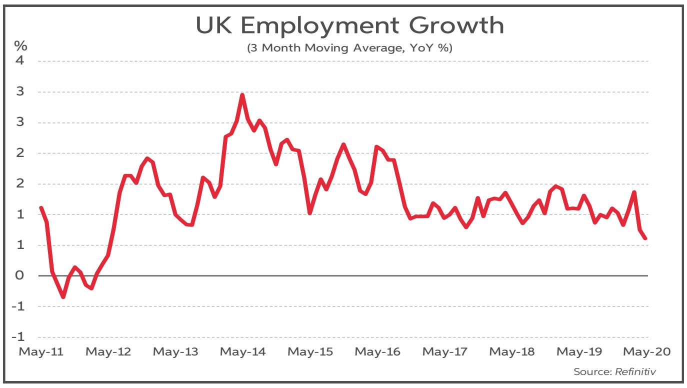
**The UK economy contracted by 2.2% in the opening quarter of 2020, which left the year-on-year growth rate at –1.7%.** The decline, the largest since 1979, reflected the initial impact of Covid-19 restrictions, with output plummeting by 5.8% in March alone. In terms of the breakdown, spending by consumers and the government fell by 2.9% and 4.1% in Q1, respectively. At the same time, fixed investment dipped by 1.1%. Net trade also acted as a drag, as the drop in exports (-13.5%) was larger than that of imports (-9.4%).




**The contraction in the opening quarter, however, pales in comparison to Q2.** The monthly estimate of GDP showed that the lockdown prompted output to plunge by 20.4% in April. Activity staged only a very modest recovery in May (+1.8%), reflecting the fact restrictions largely remained in place during the month. A more pronounced rebound is likely to be seen in the June data.

**Indeed, evidence for this was provided in the PMIs for the month.** The composite index rose to 47.7 in June, from 30.0 in May and a record low of just 13.8 in April. The increase was driven by improvements in both the manufacturing and the services indices, which were put at 50.1 and 47.1 respectively. The lower reading for the services index reflects the fact the sector has been disproportionately impacted by Covid restrictions. Positively, the composite index remained on its upward trend in July, jumping to 57.7, providing further evidence that the Covid crisis has resulted in the deepest, but shortest, recession on record. On the demand side, retail sales continued to rebound strongly in June and are now just 1% below pre-crisis levels. At the same time, the Gfk measure of consumer sentiment remained on its upward trend in July.

**With regard to the labour market, the government's furloughing scheme, which has provided income support to nearly 10m workers or around 30% of the labour force, has prevented a mass spike in lay-offs.** Although, approximately 650k employees were let go between March and June. Despite this, the unemployment rate held at 3.9% in the three months to May as a good portion of those who lost their jobs have not been 'actively seeking work' due to the pandemic. Job losses are likely to increase as some of those furloughed become 'unemployed' and as more people who are out of work come back into the labour force seeking employment. The Job Retention Scheme is currently scheduled to close on October 31st.




**On the inflation front, headline CPI edged up to 0.6% in June from 0.5%.** The core rate also edged up to 1.4% from 1.2%. The recent cut made to the VAT rate applied to the hospitality sector, combined with the negative demand shock stemming from the crisis, will act as a headwind to inflation for the foreseeable future.

**Despite the recent improvement in macro data, the outlook for the UK economy remains very challenging.** The probable deterioration of the labour market in the coming months will act as a significant headwind to consumer spending, as will heightened levels of uncertainty linked to concerns over the possible imposition of further Covid-19 related restrictions. Against this backdrop, firms will leave capex on hold. On top of this, the UK economy looks to be facing a scenario at the start of 2021 where its trading relationship with the EU will be based on either a very basic free trade agreement or on WTO rules.

**The government's ramping up of fiscal expenditure and the BoE's monetary policy stimulus efforts will provide some support to the economy.** However, the severity of the crisis will prompt a historic contraction in output this year and scarring effects from bankruptcies and job losses will weigh on the recovery in 2021. Today's forecasts from the BoE, based on the assumption of no second wave to the virus and the UK and EU agreeing an FTA, are for GDP to contract by 9.5% in 2020, before rebounding by 9% in 2021. The European Commission and IMF are much more cautious on the outlook for 2021, projecting growth of circa 6%.

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