

Novus Capital Markets Research

Back to Square One

18 August 2011

We're all doves now: faced with another downgrade to the growth outlook and a proliferation of downside risks in the global economy, the hawks have thrown in the towel (I suspect Andrew Sentance might not have done). For the first time since Sentance broke rank in June of last year the MPC is unanimous. Martin Weale and Spencer Dale still see upside risks to inflation but accept that recent developments have weakened the case for removing any of the extreme monetary accommodation put in place in response to the financial crisis. For the MPC as a whole the global economy is now the greatest risk to the UK economic outlook and is behind the central forecast of sub-2% inflation in the medium term. For Adam Posen this requires another round of QE. For the majority of the Committee lower market rates and the prospect of rates staying at 0.5% for a semi-indefinite period is enough, unless some of the downside risks emanating out of the euro area sovereign debt crisis transpire.

Credit where credit's due: we should all acknowledge that when Andrew Sentance first called for a rate hike in June 2010, he was not wrong about the outlook for inflation (not that he was right about the growth outlook). Then inflation was 3.4%; it held above 3% for the rest of 2010, moved above 4% this year and, on the MPC's latest forecast gets to 5% later this year and remains above the 2% target for at least another 12 months. Two and a half years of above-target inflation (on top of the six months that we had already had when Sentance made his call) by itself constitutes a *prima facie* case for a rate hike. So why did I think then – and now – that Sentance was wrong in his call? The answer is in the counterfactual: we cannot know what a rate hike then would have done to output and inflation. The risk was – and still is – that a rate hike would throw the economy off its fragile growth trajectory and lead to below-target inflation in the medium term – a view that all nine members of the MPC now subscribe to.

Novus Capital Markets Ltd, 29/30 Cornhill, London EC3V 3NF

www.novus-cap.com or, for a direct link to the blog, <http://www.novus-cap.com/latestnews.html>

Economist: Geoffrey Dicks (+44 (0) 20 7107 1878); **Institutional Sales:** Peter Bartlett, Neill Flack (+44 (0) 20 7107 1888)

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This month, for the first time since May 2010, the MPC was unanimous in voting for no change in rates. For 15 months prior to that the MPC was united behind the view that rates needed to stay at the 0.5% level that had been put in place in response to the financial crisis in March 2009. It was only in June 2010 that the first signs of disagreement appeared when Andrew Sentance broke ranks and called for a 25bp hike. He was joined in January by Martin Weale and in February by Spencer Dale (by which time Sentance had raised his call to 50bp). With Sentance leaving the MPC after the May meeting and Weale and Dale abandoning their hawkish stance, the only dissenting voice in August was Adam Posen who has been voting for an expansion of the QE programme for the last eleven months.

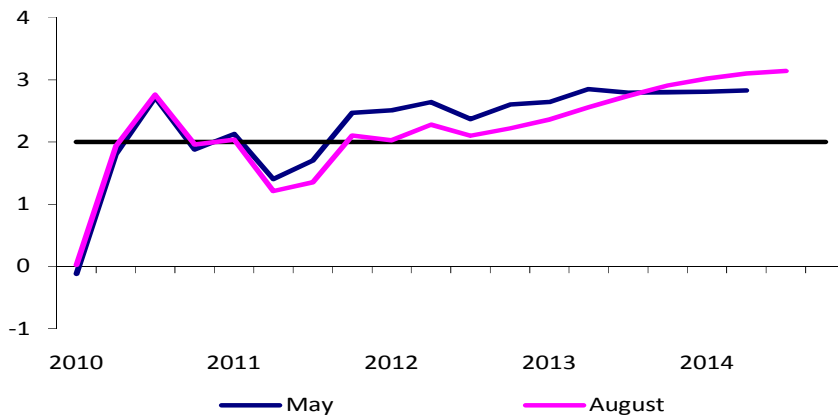
A month ago Weale and Dale were firm in their call for a 25bp hike. The case for removing some of the monetary stimulus was 'strong'. They cited upside inflation risks over the medium term from global pricing pressures and rising inflation expectations. They acknowledged that the activity data had weakened but argued that there might have been an equivalent negative effect on supply. They took little comfort from the weak earnings data since there might have been an offsetting deterioration in underlying productivity growth. Businesses might wish to rebuild their profit margins.

In the interim there has been a significant deterioration in the global economy which, as the Governor outlined in his Letter to the Chancellor, now constitutes the biggest downside risk to the UK. Developments in the euro area are a particular concern. (There was a risk that concerns surrounding the sustainability of the indebtedness of some members of the euro-area periphery could intensify again, triggering a sharper deterioration in euro-area growth, with possible implications for the functioning of the financial and banking system and for global asset prices and confidence – August Minutes.) The US, where there have been significant downward revisions to GDP growth, is also problematic.

A more difficult global outlook is reflected in another downgrade to the MPC's GDP and inflation forecasts. The central forecast (mode) for GDP growth has been cut to 1.7% this year (from 1.9% in May), to 2.2% in 2012 (from 2.5%) and to 2.6% in 2013 (from 2.8%). It is not until 2014, the fifth year of recovery, that growth moves above 3% (Chart 1). Cumulatively the August forecast shaves nearly ½% from where GDP was expected to get to in May. The 2011 GDP forecast still looks on the high side but

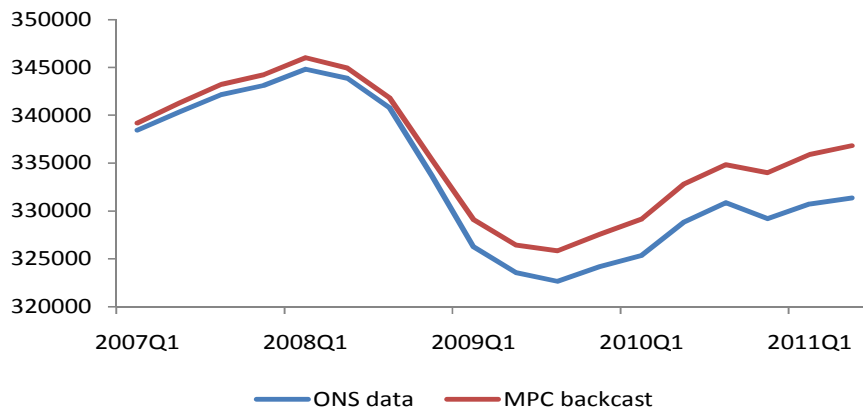
that is because the MPC runs the forecast off its own GDP backcast rather than the ONS data – a 1.6% gap has opened up between the two (Chart 2).

Chart 1: MPC GDP forecast (% y/y)



Source: BoE

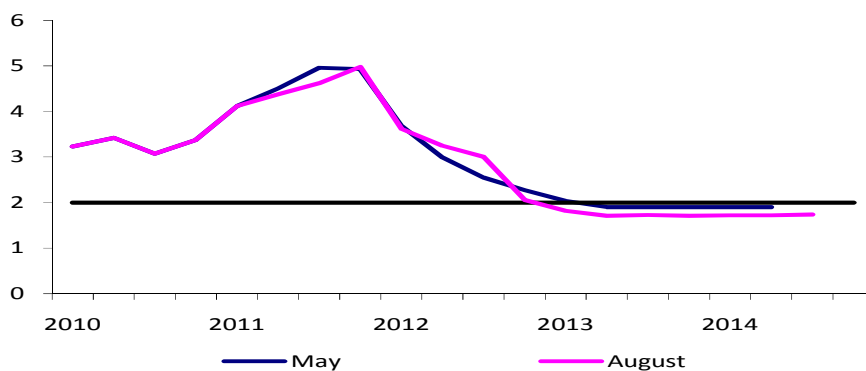
Chart 2: MPC GDP backcast vs ONS data



Source: ONS, BoE

Similarly, the central forecast for inflation is lower than in May. Inflation peaks at about the same level (fractionally below 5% on a quarterly average) but then falls faster in 2012, ending the year at 2.06% compared with 2.27% in May. Over the medium term inflation settles at about 1.7% versus 1.9% in May (Chart 3). The mean inflation forecast has also been cut by around 0.2pp (from 2.1% to 1.9%). This is reflected in Chart 5.8 of the August *Inflation Report* (which shows the probability of inflation being above the 2% target). From 13q2 onwards the odds are now slightly in favour of inflation being below 2% (though the August Minutes describe the forecast as giving a roughly equal chance of inflation being above or below target).

Chart 3: MPC CPI forecast



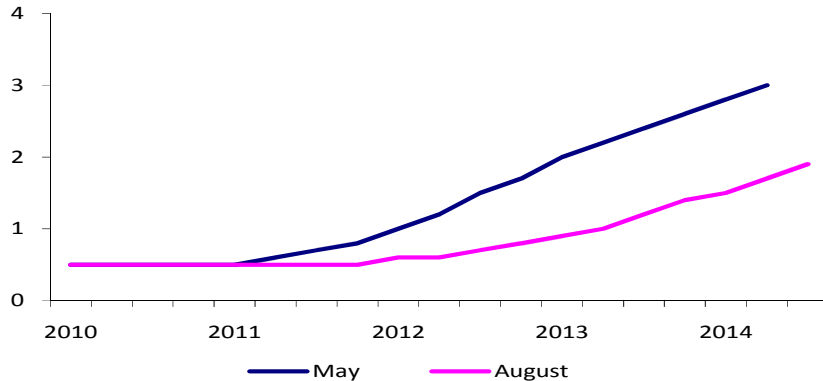
Source: BoE

Faced with yet another downgrade to the GDP and inflation forecasts, and with a deteriorating global economy pointing to downside risks to these forecasts, Weale and Dale would have had little difficulty in abandoning their hawkish stance (Andrew Sentance, whose three-month purdah comes to an end this month, is presumably made of sterner stuff). They still highlight the upside risks from a sustained period of elevated inflation and remain worried that underlying productivity growth, a restoration of company profit margins or a pass-through from import prices could leave inflation elevated. Nevertheless they were forced to conclude that 'recent developments had weakened the case for removing some of the monetary stimulus' and that on the balance of risks interest rates needed to be kept at 0.5%.

For the rest of the Committee that has always been the case. But neither, with the exception of Posen, are they yet minded to vote for QE2. The majority view is that the balance of risks to inflation over the medium term has shifted to the downside but with financial markets having effectively loosened monetary conditions by pricing in a lower rate profile, there was no immediate need for QE unless some of the downside risks were to materialise.

The forecast is based on market rates which at the time of the August forecast were pricing in a modest sequence of rate hikes starting in the second half of next year (Chart 4 – rates have eased further over the two weeks since then – and further still on the release of the Minutes this week). Without the rate hikes the central forecast for inflation would still be fractionally under 2% but on the balance of risks (given by the mean forecast) inflation would be closer to 2%. The implication would appear to be that unless the whole GDP-inflation profile shifts down again, rates can be kept unchanged for a semi-indefinite period and a further round of QE might not be needed.

Chart 4: Market interest rates



Source: BoE

For the longstanding doves on the MPC the pick-up in inflation from the Sep09 low of 1.1% was always temporary, the product of two successive 2½pp increases in VAT (CPIY inflation, which excludes indirect taxes, is running at around 3%), the feed-through of the (one-off) fall in sterling to import prices and

then consumer prices and upward pressure on commodity prices from the global economy. The pick-up may be temporary (though it has been going on for two years) – and the weaker global economic outlook suggests the pressure on commodity prices should fade (oil prices have already fallen back) – but that will not stop inflation reaching 5% over the coming months as the latest round of utility price increases feeds through.

I have sided with the doves throughout the last year so it may be nit-picking to quarrel with the view expressed in the August Minutes that ‘the key upside risk continued to be that inflation would be elevated for longer than the Committee expected’. If the period of elevated inflation were a problem *per se* then, since CPI inflation has been above target for the last 20 months (and for 20 out of the 26 months before that), and is forecast to remain above target for at least another year, we would already be in trouble. What is critical is whether a period of elevated inflation is reflected in the wage bargain and here, so far at least, things are going the way of the doves. Still, with some prices linked to the RPI (most obviously rail fares) the risks to earnings are probably to the upside.

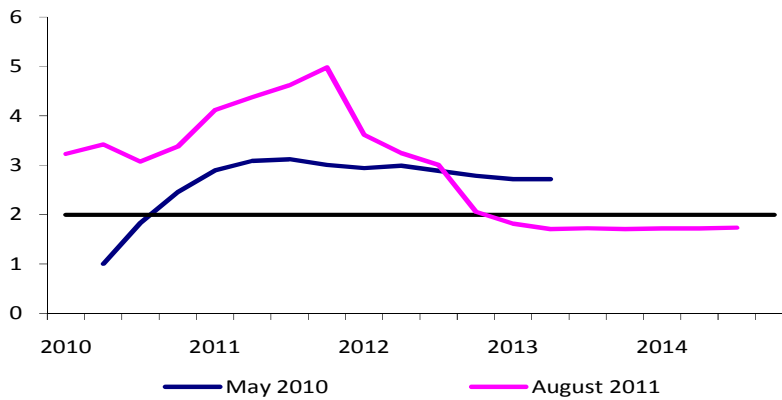
One of the first blogs I wrote on my return from the OBR (10 December 2010) was sub-titled ‘why Andrew Sentance is wrong (even if he is right)’¹. The gist of my argument was that ‘even if Sentance is right about the growth and inflation outlook *ex ante*, he might still be wrong *ex post*. In a still-fragile environment, a rate hike, and the signal it gives at this juncture, would risk tipping the economy back onto a slow growth – sub-target inflation trajectory’.

As then, I should acknowledge that Andrew Sentance was not wrong about inflation when he first called for a rate hike in June of last year (though his relative pessimism was based on an over-optimistic view of where the real economy would go). At the time the MPC was forecasting a sharp drop in inflation with almost immediate effect. Its May 2010 forecast showed CPI inflation dropping from a 10q2 average of 3.3% to 2.3% by the end of the year and to a low of 1.3% by the end of 2011. Inflation was expected to be below the 2% target throughout 2011, 2012 and 2013 (Chart 5). Compared with the outturn over the last 12 months and its current forecast for the next 12 months, the MPC’s May 2010 forecast was

¹ <http://www.novus-cap.com/pics/blogpdfs/10Dec2010.pdf>

particularly poor. Sentance was far more prescient on inflation than the rest of his colleagues on the MPC.

Chart 5: MPC CPI forecast



Source: BoE

On the MPC's current forecast CPI inflation will be above target until the end of 2012, a full 2½ years from Sentance's first call. That alone is enough to establish a *prima facie* case for a hike though what we can't do is the counter-factual (what would have happened to the real economy and inflation if rates had been raised). I remain of the view that raising rates then, or at any time since, would still have been too risky from the point of view of the real economy.

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Novus Capital Markets Limited, 29-30 Cornhill, London. EC3V 3NF.

Tel: +44 (020) 7107 1850 Fax: +44 (020) 7107 1851. Website: www.novus-cap.com