3 November 2016

Bank of England review

BoE shifts from easing to neutral bias – we no longer expect a further rate cut

- **As expected, the Bank of England (BoE) left monetary policy unchanged at the November meeting.**
- **However, the tone was more hawkish than expected as it shifted from an easing bias to a neutral bias, saying that it *"can respond in either direction"*.**
- **Due to this shift and the resilient economic data we no longer expect the bank to ease monetary policy further.**
- **Meanwhile, the High Court ruled that the parliament – not the government – has the power to trigger Article 50. We still think it will be triggered eventually but the ruling makes a 'softer' Brexit more likely.**
- **EUR/GBP declined significantly today – in the short term, we expect GBP trading to be more volatile and further GBP appreciation should not be ruled out.**
- **Over the medium term, we do not see today's events as a major game changer for GBP. We still target EUR/GBP at 0.91 in 3M and 0.92 in 6M.**

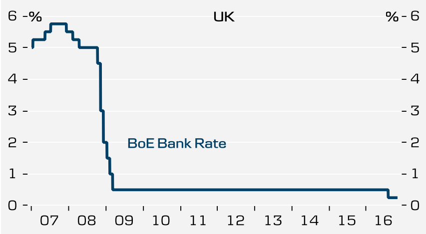
We no longer expect BoE cut next year

As expected, the BoE left its monetary policy unchanged at the November meeting. Bank Rate was kept at 0.25%, the target for the stock of government bond purchases and the target for the stock of corporate bond purchases were kept at GBP435bn and GBP10bn, respectively, and there were no changes to the new Term Funding Scheme (TFS).

The tone was more hawkish than expected as it shifted from an easing bias to a neutral bias, saying it *'can respond in either direction'*. The reason is that the economic data has been remarkably resilient to the Brexit uncertainties while the steep GBP depreciation means that CPI inflation will increase sharply next year. It seems that the BoE is quite satisfied that its actions have supported the economy and moved inflation back to higher levels consistent with the 2% target. The BoE now expects higher short-term real GDP growth as economic data so far has been resilient. The bank also expects CPI inflation to be higher than the August projections as the GBP has depreciated further. The BoE expects CPI inflation to peak just below 3% in the coming years.

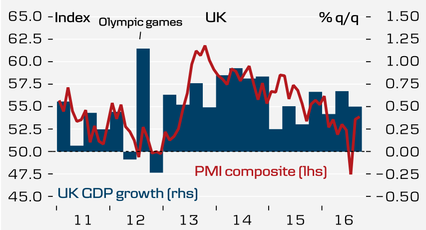
BoE's shift to neutral bias and resilient economic data mean we no longer expect the bank to ease monetary policy further (previously we expected a cut in February). While we think it is unlikely that the BoE will tighten monetary policy in a time of elevated political uncertainty, we think we need to see slower growth and/or higher unemployment before easing becomes likely again.

BoE on hold as expected – but shifted from easing to neutral bias



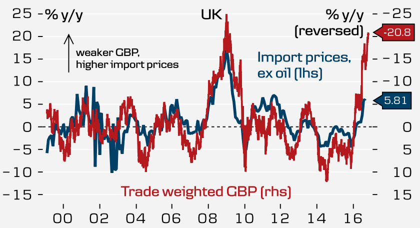
Source: Bank of England

Economy has been resilient to Brexit uncertainties so far



Source: ONS, Markit Economics

Weaker GBP implies higher import prices and hence higher inflation



Source: ONS, Bank of England

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High court says parliament – not government – can trigger Article 50

Today, the UK High Court ruled that it is the parliament – not the government – that has the power to trigger Article 50. A spokesperson from the government said that it will appeal the verdict – we should get a final ruling from the Supreme Court in December. **While we still think Article 50 will be triggered eventually** (although the triggering may be delayed past March), **we think it is a signal that the parliament may be more heavily involved in the negotiation process**, as the High Court has said that the government does not have the power to execute Brexit alone. The reason why we still think Article 50 will be triggered is that May has been very explicit about the new government's intentions, as she has said repeatedly that "Brexit means Brexit". **If we are right that the parliament will be more involved in the negotiation process, it means that a 'softer' Brexit has become more likely**, as a majority of the members of parliament have a pro-EU stance and voted for remain.

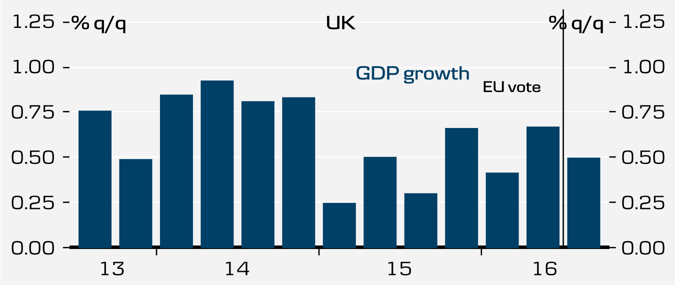
Over the medium term, we do not see today's events as a major game changer for GBP

EUR/GBP declined significantly today due to the combination of the High Court's ruling and the BoE's shift to a neutral stance. **In the short term, we expect GBP trading to be more volatile and further GBP appreciation should not be ruled out** – ahead of the US election in particular on 8 November we could see a further reduction in short GBP/USD bets.

Over the medium term, we do not see today's events as a major game changer for GBP. First of all, the market did not price any further rate cuts from the BoE ahead of the meeting. Hence, the BoE's shift in its stance actually just reflects the market's pricing. Moreover, we would like to stress that, although we previously expected additional BoE easing in the form of a 15bp rate cut in February, our call for a weaker GBP is a fundamental story. Hence, we still think that the combination of significant economic imbalances (large current account deficit and a negative net international investment position) and Brexit uncertainties justifies a significant undervaluation of the GBP. In our view, it is too early to judge whether today's High Court ruling will drastically change the prospect of Brexit. **We still target EUR/GBP at 0.91 in 3M and 0.92 in 6M.**

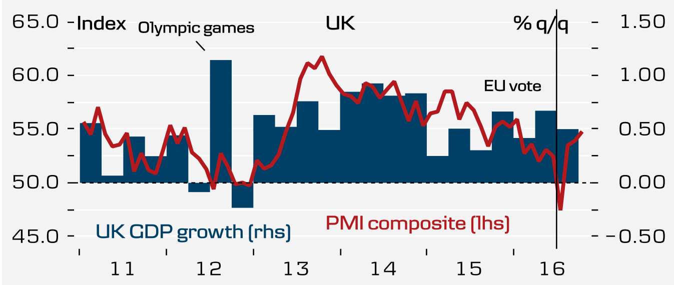
GDP growth has been resilient to Brexit uncertainties

GDP growth was resilient in Q3



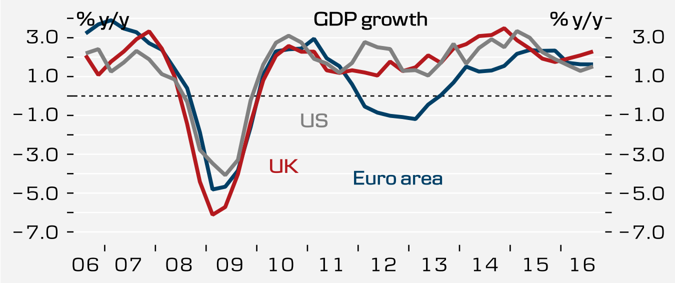
Source: ONS

PMIs suggest growth continued in October



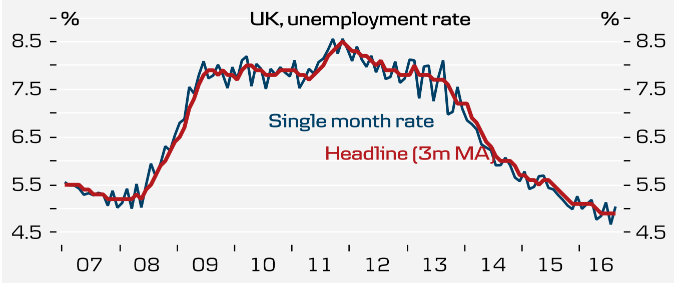
Source: ONS, Markit Economics

Higher annual GDP growth than in US and euro area



Source: ONS, Eurostat, BEA, Danske Bank calculations

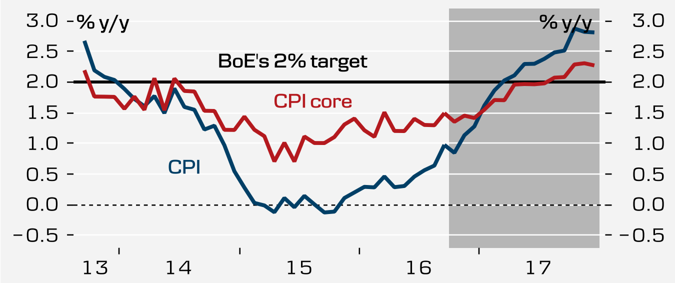
Unemployment has not taken hit from Brexit uncertainty yet



Source: ONS, Bank of England

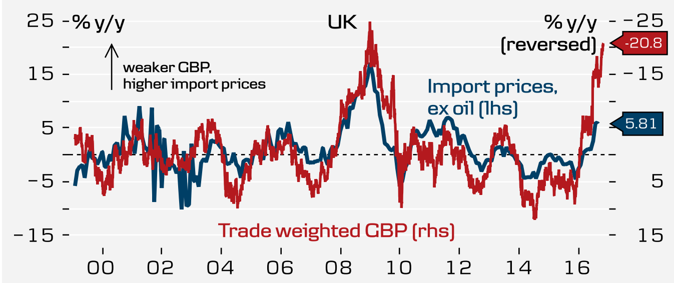
Inflation expected to rise

CPI inflation to increase sharply in coming months



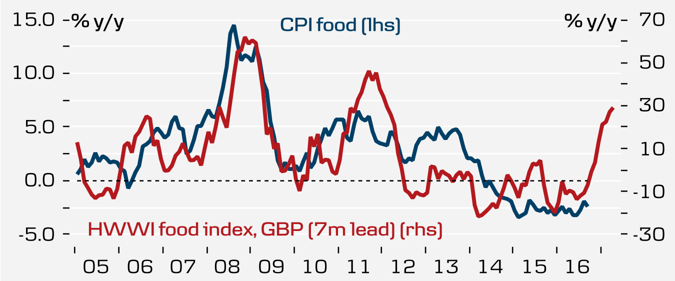
Source: ONS, Danske Bank

Weaker GBP implies higher import prices



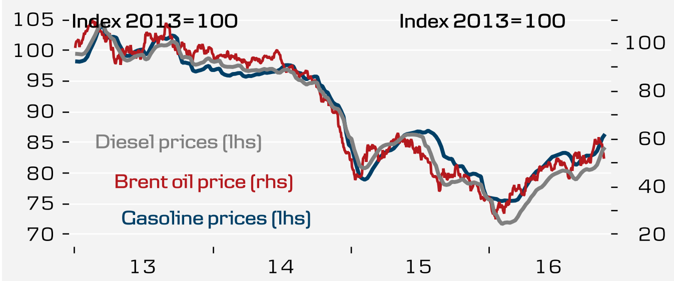
Source: ONS, Bank of England

Food deflation to end soon



Source: ONS, Bloomberg

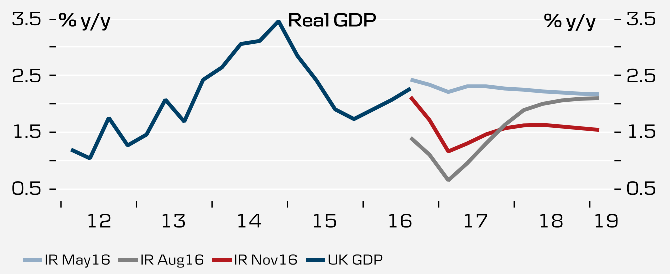
Higher energy prices



Source: Bloomberg, UK government

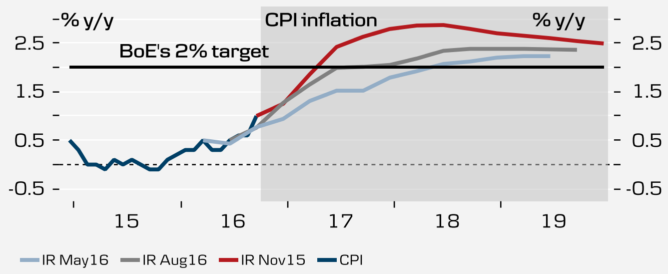
BoE revises up projections for short-term GDP growth and CPI inflation

BoE revises up real GDP growth in short term (but revised down long term)



Source: ONS, Bank of England

BoE has revised up CPI inflation projections due to further GBP weakening – to rise just below 3% in coming years



Source: ONS, Bank of England

Disclosure

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj (Senior Analyst) and Morten Helt (Senior Analyst).

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None

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