Amplifying Global FX Capital

28 June 2017

BoE Carney raises odds of a hike; latest global yield developments

Carney's speech delivered during a panel discussion at the ECB central bank conference focused on business investment developments in the UK since the 2007/09 Global Financial Crisis.

Carney was more optimistic about the current business investment outlook, making similar observations to BoE Chief Economist and MPC member Haldane last week.

A theme several central bankers have commented on in recent outings is the improved global growth outlook.

Carney said, "A strengthening global economy should tempt UK companies to do so [invest], particularly since UK companies are generally competitive given the recent fall in sterling. Indeed, the broad-based global recovery is creating the possibility of a self-reinforcing revival in investment. The Bank of England estimates that more than 80% of the world economy is now growing above potential. Global measures of industrial production and capital goods orders, as well as world trade, have strengthened markedly over the past year, suggesting some rotation in the composition of global demand towards investment. With that more favourable outlook, investment intentions are now rising around the world."

I might be biased at the moment towards looking for evidence that central bankers are seeing scope for higher real rates, less focused on under-shooting inflation, but Carney also made reference to this theme. He said, "If these intentions are realised [to invest], the global equilibrium interest rate could rise somewhat, making a given policy setting more accommodative. The extent to which it does will depend on other secular factors that have been holding it down, including demographics, debt overhangs and the capital intensity of production."

There is a line of thinking here, that was also apparent in Draghi's speech yesterday, that by just standing still, monetary conditions get easier as a business investment and the broader economy recovers.

Earlier this week, the BoE reinstated cyclical buffers for its banks. This was part of its biannual financial stability report. It requires banks to increase their capital ratios by 0.5%, and expects to raise the buffer by additional 0.5% at its November review. And it announced bringing forward its inclusion of consumer credit into the annual stress test this year, and requiring banks to again include central bank reserves in their leverage ratio measure. These measures are designed to return the standards on bank stability measures to where they were before the Brexit vote. To some degree, they represent some tightening in credit conditions that might lessen the immediate need to raise rates. Of course, these moves also indicate that the BoE is now seeing reasons to remove policy accommodation, and the next step might be removing some of the policy easing implemented since Brexit.

Carney made reference to these changes to bank macroprudential measures in his speech, but didn't suggest they play into the monetary policy decision at all.

He noted that spare capacity in the UK economy has eroded, and the more it does, the BoE's "tolerance for above average inflation falls."

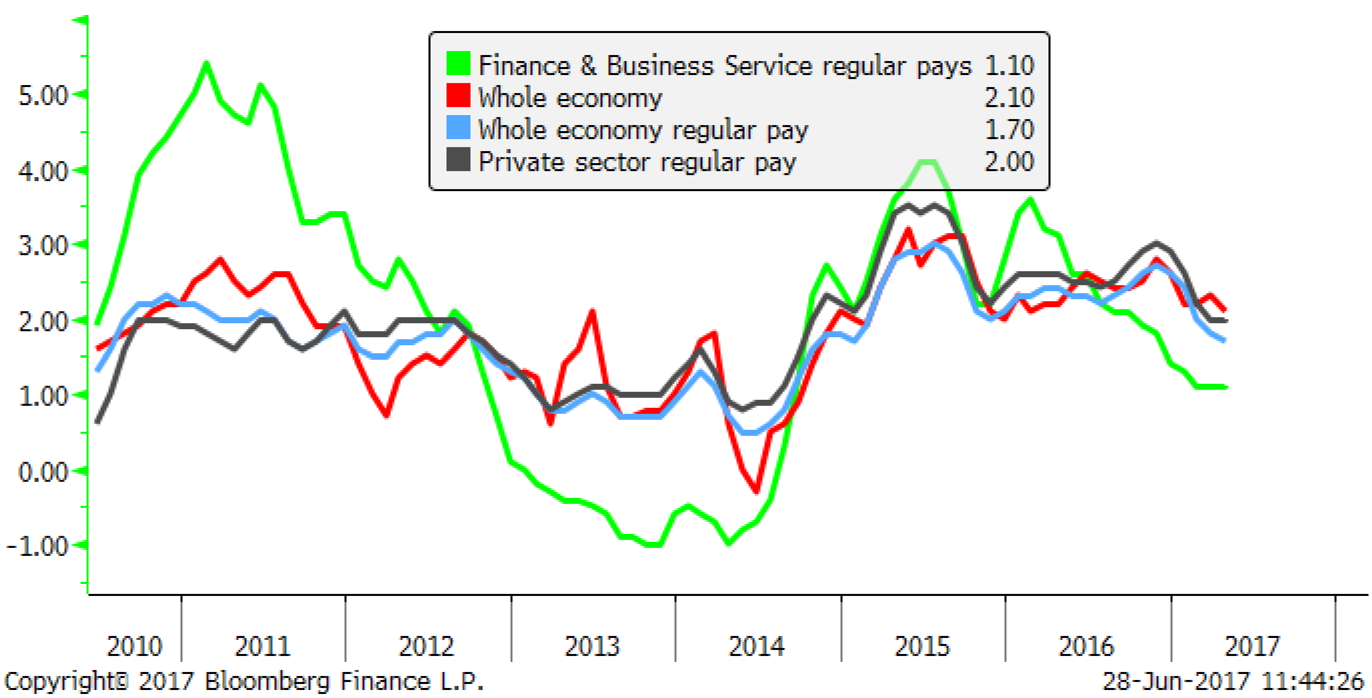
He said he is watching for evidence of further declines in this spare capacity, and such evidence may require policy tightening.

He said, "The extent to which the trade-off moves in that direction will depend on the extent to which weaker consumption growth is offset by other components of demand including business investment, whether wages and unit labour costs begin to firm, and more generally, how the economy reacts to both tighter financial conditions and the reality of Brexit negotiations. These are some of the issues that the MPC will debate in the coming months".

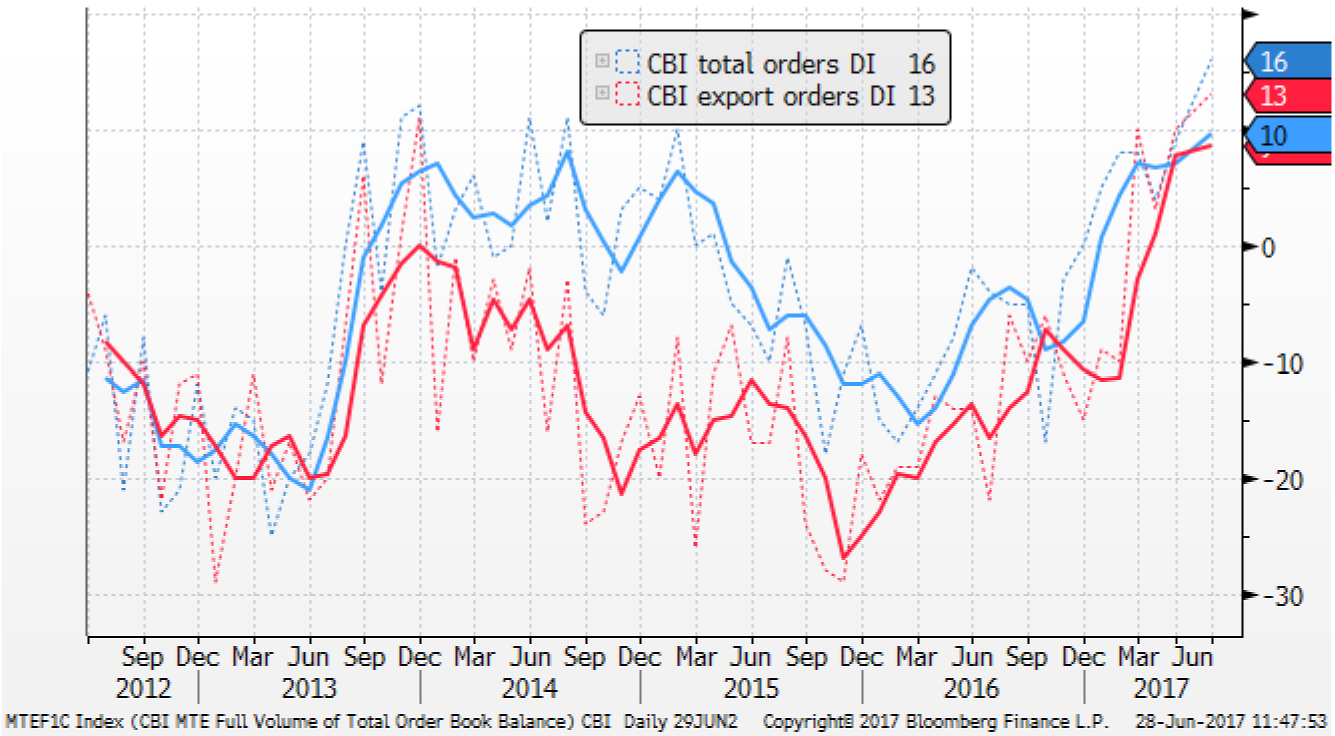
This still suggests that the onus is on the data to get the BoE over the line to hike. Carney is expressing optimism that business investment will take over from consumption and help drive the UK economy, but he is also acknowledging that it faces unique headwinds arising from Brexit.

Wages growth has been falling all year, so it is hard to see this being the factor that triggers a rate rise, but since Carney mentioned wages, they will be watched closely for even modest sign of rebound.

Waged growth %y/y



Providing more support for the case for a rate hike is the CBI industrial orders data; on a three-month moving average basis, total order and export orders diffusion indices are at highs since the 1980s. This suggests that the weak exchange rate and stronger global growth are supporting business activity.



Consumer consumption indicators have tended to be weak. Retail sales were much weaker than expected in May, raising fears that rising prices and declining real wages would begin to weigh more on consumption.

In other comments, and in the recent BoE MPC statement, Carney and team have been careful to say that any rate rises would be gradual and limited. They are thinking more at this stage about whether it is appropriate to remove some of the addiitonal stimilus provided since Brexit.

Since it's about some removal of additional accommodation, it may not take all that much sign of continued improvement in business activity and stabilization in consumer activity to make the case for a hike. On the other hand, a lot of the uncertainty related to Brexit will take ages to be resolved, at it remains to be seen if this will prove to be a significant headwind to recovery. So the BoE is likely to raise rates cautiously.

Canada rates market now pricing in almost 70% chance of a rate hike on 12 July

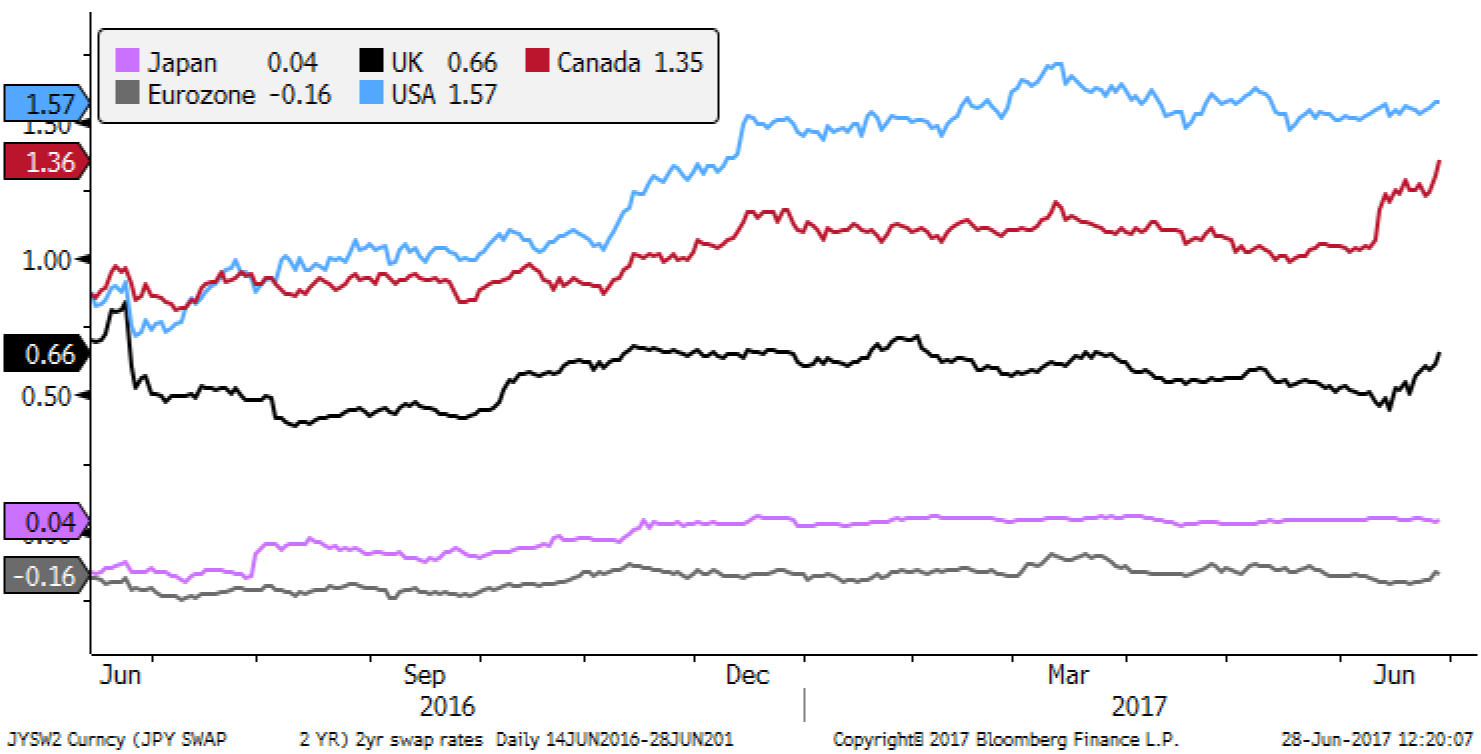
UK rates market is now pricing in about 23% chance of a hike on 3 August.

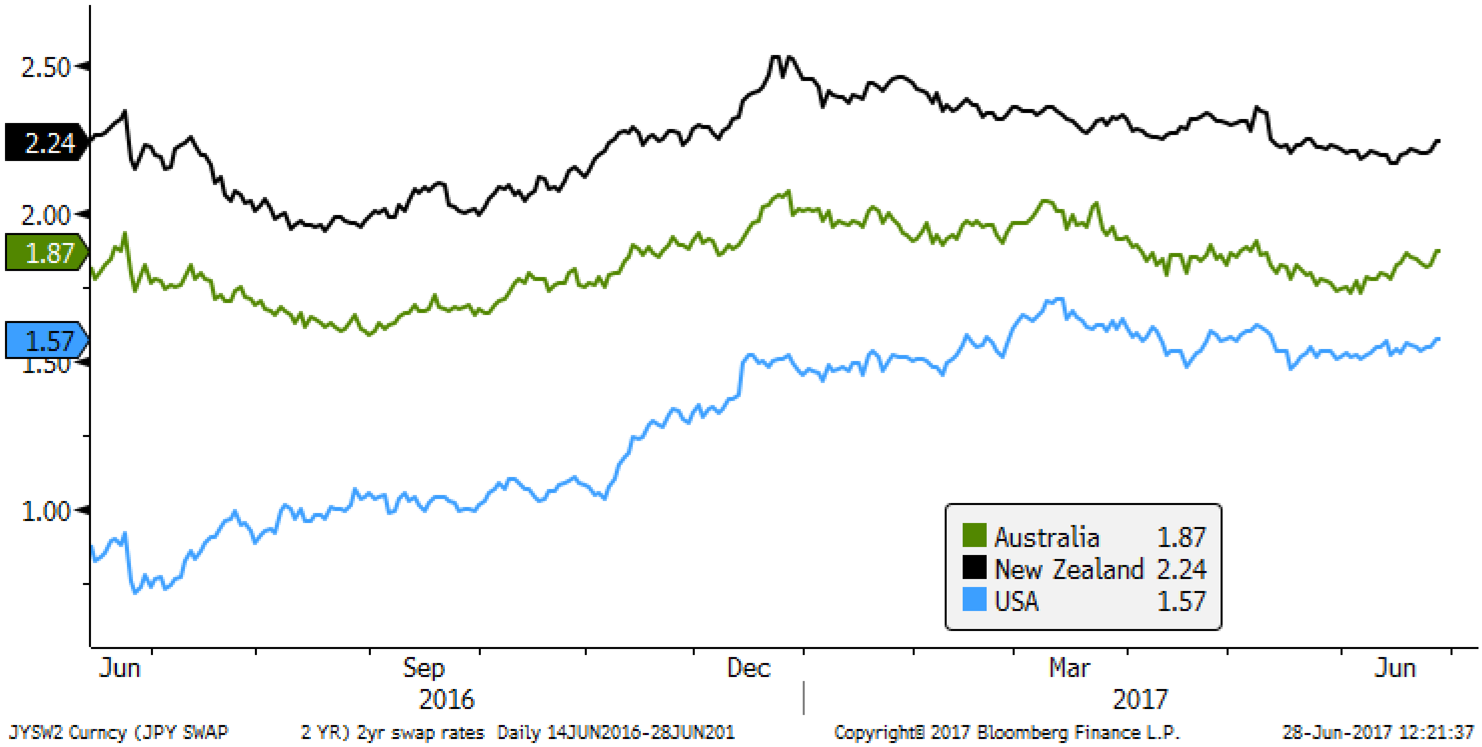
USA rate market is pricing in only 29% chance of a hike by 20 Sep, 52% of one hike by 13-December.

Australia and New Zealand have odds of a hike creeping in by early next year.

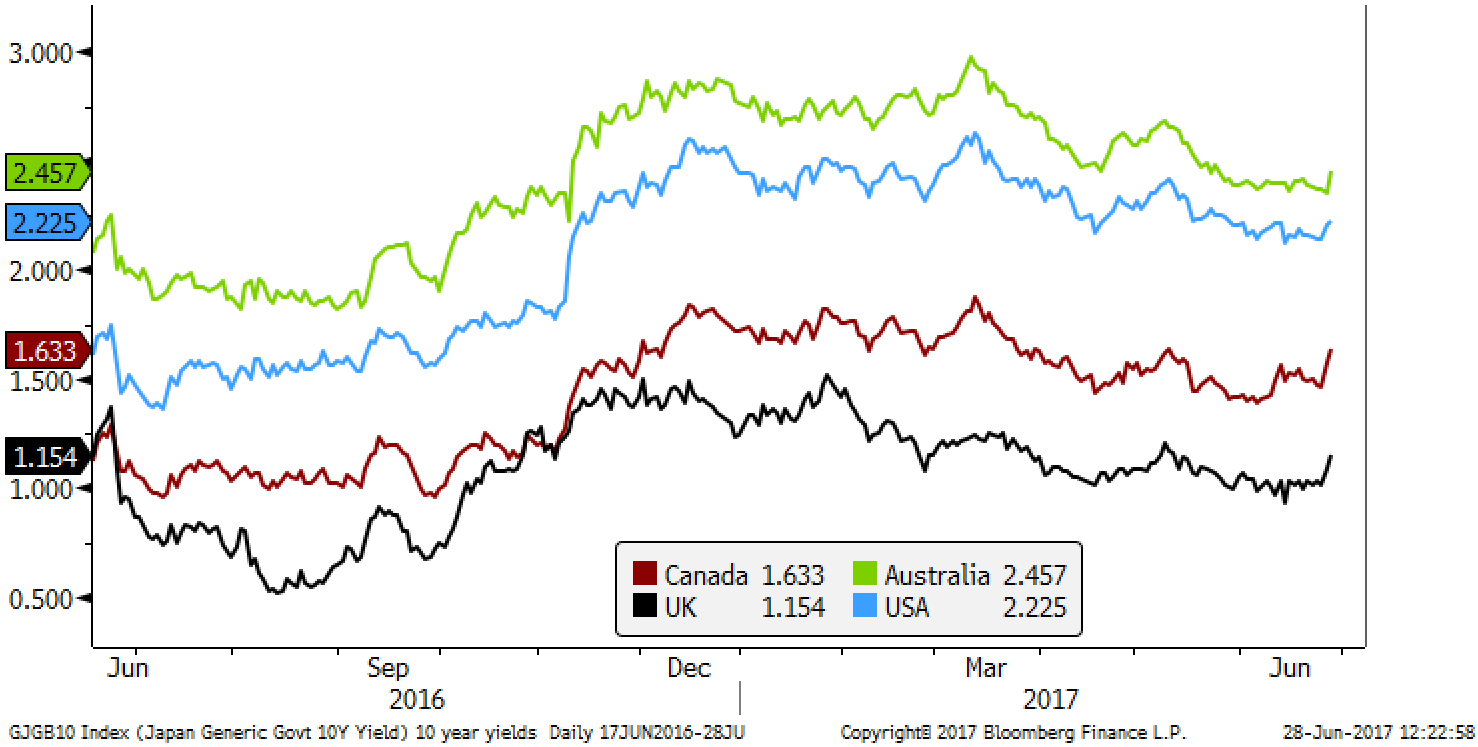
GBP vs the 2yr swap rate spread

2 yr swap rates – both Canada and UK rates rise over 4bp on Wednesday





10 year bond yields jump in recent days



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