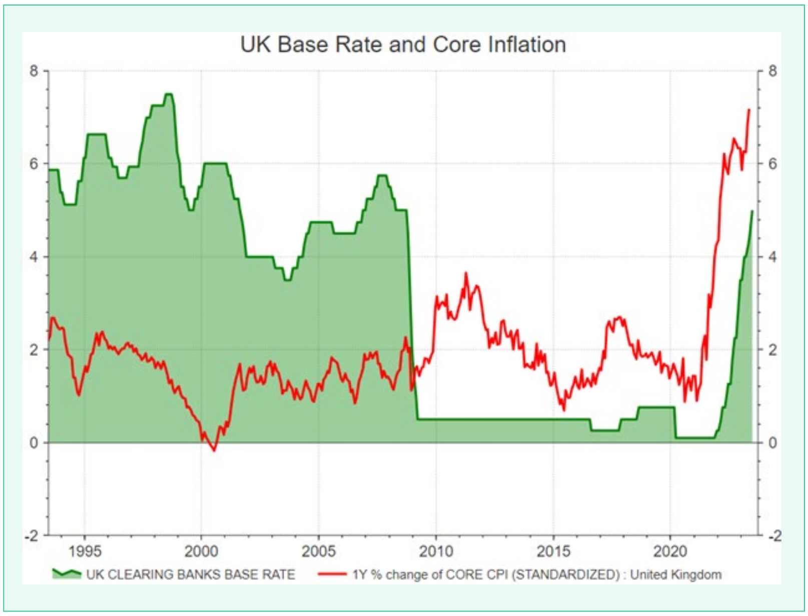
The Bank of England's Mulligans

If monetary policy is akin to playing a round of golf with only a driver (i.e. interest rates), then the bunker that Andrew Bailey finds himself in just got a whole lot deeper after the recent 50 bps rate hike.

However, it's probably fair to say that this round of monetary policy is still 'dovish' by historical standards. The timeframe leading up to the Great Financial Crisis witnessed periods where interest rates tended to be above Core CPI and wage growth (as Chart A shows). Despite the recent rate hikes, it is still significantly below both. As well, the Government is hardly helping with their lax fiscal approach, running an eye watering budget deficit of £146bn.

Chart A



Source: Collidr, Refinitiv Datastream

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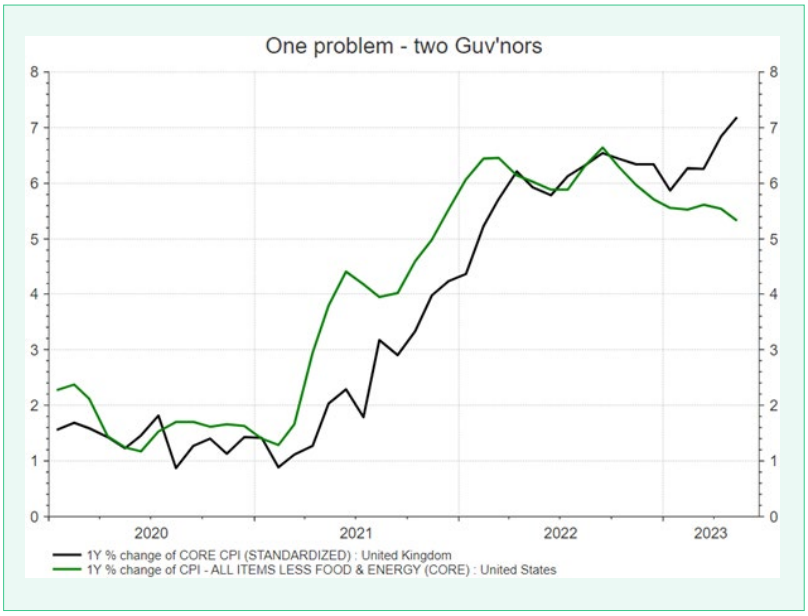
One has to wonder, as western central banks continue with their efforts to tame inflation, whether we have entered that critical point where any further actions may prove to be more counterproductive and harmful than letting things play out at this stage.

Let me explain.

The UK is in a different situation

What sets the BoE apart from the Fed is that at least the Fed's medicine seems to be working (even if it is slower than people would like). Chart B shows the path of Core Inflation in the UK and the US for the period leading up to COVID-19 to May 2023. Unlike the US, Core Inflation is still on the rise in the UK. While some might say that Powell has rightfully paused on rate hikes, Andrew Bailey appears to have panicked. Or are they being too harsh on him?

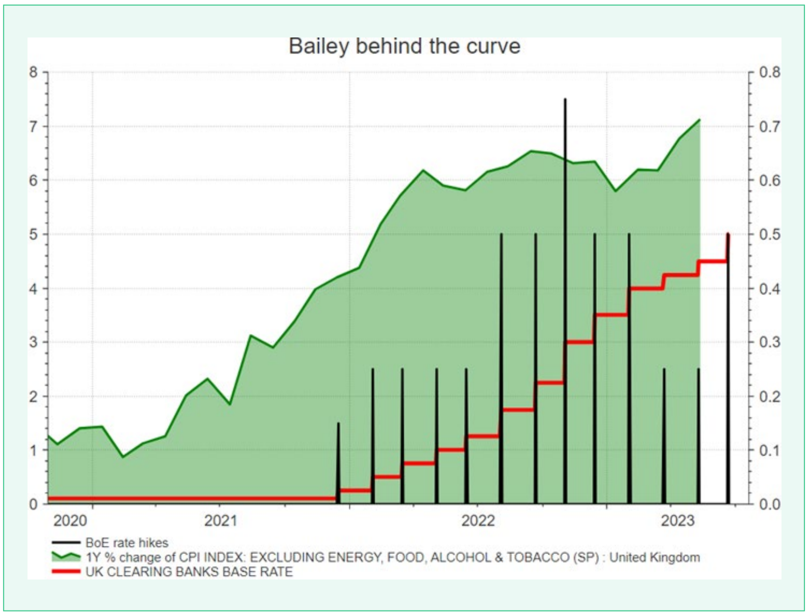
Chart B



Source: Collidr, Refinitiv Datastream

On one hand, there were plenty of economists calling on Mr. Bailey to start raising rates (or at least end QE) much earlier than when he finally did. For instance, when news emerged of the first Covid vaccine in November 2020 (often referred to as 'Pfizer Monday'), it took 13 months before he raised rates from – what looks like now to be – the absurdly low level of 0.1%, despite Core CPI starting to rise above the 2% target (as shown in Chart C).

Chart C



Source: Collidr, Refinitiv Datastream

Conversely, it wouldn't be surprising to say who wasn't calling on him to raise rates at a faster pace in 2021 – the vast majority of MP's. The very same MP's now calling on the government to 'do something' (of which, one might have thought, running a £146bn budget deficit was doing quite a lot, actually).

While it's easy to criticise the Bank of England at this point, the reality is that if you asked anyone from the 1980's, which might include the ghost of Margaret Thatcher to Yosser Hughes (yes, he of the TV drama 'Boys from the Blackstuff'), they would probably tell you how tough and painful the fight against inflation can be.

As mentioned, maybe we've reached the point where this fight has been addressed? For two members of the MPC, Swati Dhingra and Silvana Tenreyro, argued in vain to keep interest rates at 4.5%. The minutes from the recent BoE vote helps explain why they believe inflation will fall without a further tightening of policy. There were two main factors underlying this belief:

First, as energy prices and other global cost-push shocks continue to decline over the course of 2023, goods-price inflation should fall sharply (which has already started to happen).

Second, as monetary policy has a lag effect, it's still too early to gauge the true impact to the economy from the sizeable rate increases that have taken place to date.

Reading between the lines, what they appear to be saying is that inflation is already falling. Not to mention, if you know where to look, there's a further decrease to come, as energy bills start to fall and the big hikes from last year fall out of the annual inflation calculation.

In March 2022, utility bills went up 48% over the previous month, and increased by another 25% in September 2022. However, we know that these bills will fall in July this year, as well as again in September. So, not only will last year's July rise fall out of the upcoming inflation numbers, but we will see negative numbers included for both July and September 2023.

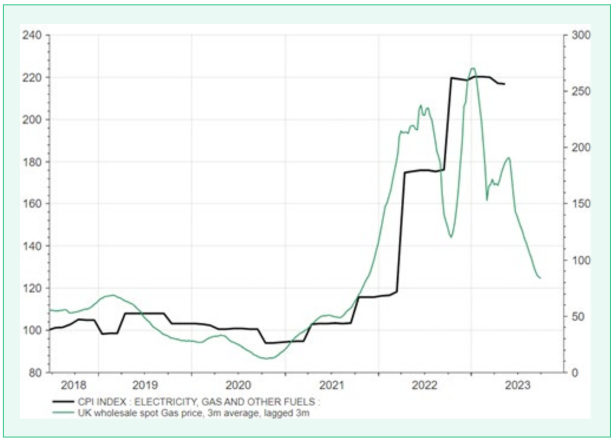
Housing – the primary pressure point?

One of the largest knock-on effects of rising rates is the impact on mortgages, and to the housing market in general. One can never underestimate the importance of financing costs and their impact on housing.

But while the media might like to focus on the very negative aspects of this environment, unlike previous housing generations, say the early 1990s, more people own their own home outright now than have a mortgage, and most of these mortgages are on fixed rates. Therefore, in terms of the 'cold' numbers, while a minority of individuals will face a mortgage hike, everyone in the UK will see lower energy bills over the next 12 months, and this will help lessen the effects of inflation.

Therefore, at some point soon, energy prices will start to fall (this trend is reflected in Chart D) and the previous rate hikes may already be helping to reduce inflation (if you recognise that it takes at least six months for the rate hike to start having an effect – Chart E).

Chart D



Source: Collidr, Refinitiv Datastream

Chart E

Source: Collidr, Refinitiv Datastream

What does this mean to investors?

Markets have significantly changed their expectations on the level and speed of the rate hikes, and they could change their mind again. As a result, Gilts are likely to remain a very volatile asset class.

Whilst it's easy to be pessimistic about the outlook for the UK economy, and the usual suspects are currently doing just that, UK equities are an entirely different story. When compared to other developed markets, many offer attractive absolute and relative valuations, and the majority of profits for large-cap UK equities (FTSE100) are derived from overseas.

For now, let's just hope Mr. Bailey finds another club in his bag of tricks, or at least gets through this round without hitting into more hazards.