RECOMMENDED READING 26.10.15

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From:

MI Update: How do market contacts explain the fall in short rates since the *August Inflation Report?*

This note outlines market contacts' views on the current level of UK short rates. It should be read in conjunction with a companion note on the drivers of short rates since the August IR from MFAD. ***Section A*** *looks at the drivers behind the lower market curve since the August Inflation Report,* ***Section B*** *assesses the extent to which economists' monetary policy expectations have also fallen, and* ***Section C*** *briefly summarises contact expectations for the upcoming November Inflation Report.*

Key Points

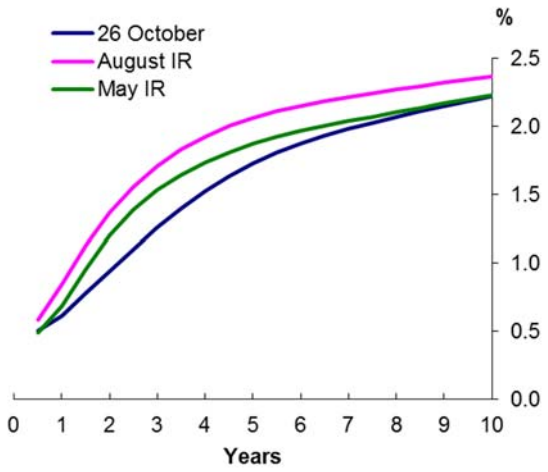
- The market curve has fallen substantially since the August *Inflation Report (IR)*. The market implied date of the first rate rise is now Q1 2017, compared with Q2 2016 in August.
- Contacts suggested that the marked fall in the sterling curve since Aug *IR* reflected a change in market expectations for UK policy rates, in particular following the spike in volatility in August and the September FOMC, but some also thought that changes in term premia may have played a role.
- Uncertainty about the extent of impact from a potential slowdown in global growth was a major factor playing on people's minds. A number of contacts also thought recent UK data releases had signalled some concerns around the recovery. Relatively dovish communications by certain MPC members was also said to have played a role. Some contacts also reported that positioning in sterling markets is light – possibly exacerbating the falls in the yield curve.
- While the market curve has fallen materially since the *August Inflation Report*, economists' Bank Rate expectations have fallen only slightly. The latest Reuters survey of economists shows a shift in the median expectation of the first Bank Rate rise to Q2 2016, from Q1 2016 last month. There remains a notable gap (around 10 months) between the timing of the first rate rise implied by the market curve and economists' survey based expectations.
- Few contacts had firm expectations of the November *IR*, but those who did expected the MPC to broadly validate the current path implied by market rates. Most contacts expected the CPI forecast to be above the 2% target, but in the same order of magnitude as August *IR* (0.1pp).

Sterling Markets Division
27.10.15

A. What explains the markedly lower market curve since the August *Inflation Report*?

1. The sterling instantaneous forward OIS curve, which serves as a proxy for the market's mean Bank Rate expectation in the *Inflation Report (IR)* forecasts, has fallen substantially since the August *IR* (**Chart 1**). The market implied date of the first rate rise is now Q1 2017, compared with Q2 2016 in August. As discussed in the companion MFAD note the fall in the market curve may reflect both a fall in future policy rate expectations and lower term premia. Our conversations with contacts suggests that the fall in the sterling curve since Aug *IR* primarily reflects a change in market expectations for UK policy rates, but some also think that changes in term premia may have played a role. The rest of this section discusses these factors in more detail.

Chart 1: Sterling instantaneous forward OIS curve



2. Contacts felt that the biggest driver of the sterling curve since August was the increasing uncertainty around the outlook for global growth and inflation, citing both the August financial market volatility and the FOMC's subsequent decision to leave policy rates unchanged in September as key factors. In fact, the move in sterling rates is broadly in line with a similar move in US short rates since the last *Inflation Report*, reflecting a historical correlation between the two markets. While some contacts were mindful that the MPC had downplayed the direct downside impact from China on the UK in its September minutes, they were generally looking to the November IR for further clarity on the extent that current international dynamics will impact the UK growth and inflation outlook (see **Section C**).

3. A number of contacts also thought recent UK data releases had signalled some concerns around the recovery. Wage data remains the most important focus for market contacts (they see these data as the key variable in the MPC's reaction function). Consequently, the recent levelling off of wage growth (which increased sharply earlier this year) was cited as another factor behind concerns around the UK economy. A number of contacts also placed weight on weakening forward looking measures as grounds for their concerns. For example, services PMI data published at the beginning of October fell short of the market expectations, and the spot CPI figure fell (unexpectedly) to -0.1% a few days later.

4. Several contacts mentioned that the current economic environment was offering justification to some relatively dovish communications by certain MPC members. Contacts cited a greater focus on the narrative of secular stagnation espoused by Andy Haldane, as well as Gertjan Vlieghe's comments at the TSC hearing being seen as closer to that view. Further, some contacts felt that the lack of any further MPC communications pushing against the current level of market pricing may have implicitly validated the curve.

5. Contacts also reported that positioning in sterling markets is light – possibly exacerbating the falls in the market curve. The absence of hedge funds taking short positions was cited by some as an explanation for the steady decline in market rates. These market participants would normally be going short (positioning for an increase in Bank Rate) and pushing rates higher. Contacts noted that many hedge funds were reluctant to

position short again, given the money that their funds had consistently lost on this strategy over the last few years. Some contacts noted that those firms interested in trading monetary policy views are more likely to speculate in foreign currency markets – e.g. the US Dollar (expecting a hike) or euro (expecting a cut), given the possibility of an earlier policy change than the UK. Market contacts felt that hedge funds often only positioned when a policy change was expected in the next 6-9 months. The timing of taking short positions was extremely important, and contacts thought that an ever higher level of conviction level is needed to go short. While most contacts continue to expect that the next MPC policy move will be a rate hike, the possibility of rate cuts was mentioned again. Short sterling options data is now suggesting an increase in market positioning for a possible cut in Bank Rate (**Chart 2**). Some contacts attributed this positioning to one well-known hedge fund which is known for taking large positions in short sterling options. The option-implied probability distribution from short sterling options has also shifted to the left (**Chart 3**).

Chart 2: Open interest in short sterling options

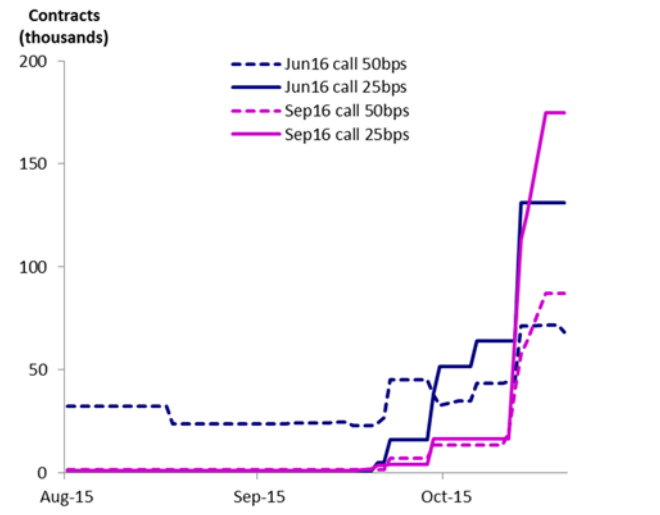
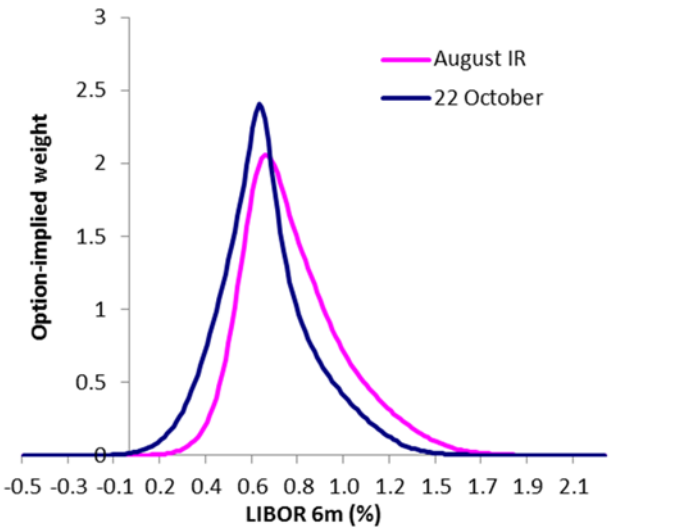


Chart 3: Option-implied PDFs (6m constant maturity)



B. Have economists' monetary policy expectations fallen too?

6. While the market curve has fallen since the *August Inflation Report*, professional forecasters' expectations for Bank Rate have fallen only slightly. The latest Reuters survey of economists shows a shift in the median expectation of the first Bank Rate rise to Q2 2016, from Q1 2016 last month. Although this has caused the gap between the market curve and Reuter's economists to narrow to around nine months, the UK market curve remains below the path expected by the Survey of Economic Forecasters (SEF) and the path of Bank Rate forecast by the Reuters survey (**Chart 4**). The gap between the economists and the market is larger in the UK than the US (**Chart 5**).

7. Part of the difference between the market and economists may be explained by the fact that economists are slow to update their views, and have a reluctance to move their forecasts significantly. Contacts thought that even those who had changed their forecasts since the last *Report* had not kept pace with developments in the economic outlook. Some contacts speculated that the conviction amongst economists about their own forecasts was low at the moment.

8. Another possible explanation for the difference could be weight placed on economic data. Market contacts tended to focus on the most forward looking economic measures, such as PMI data and Bank of England Agent surveys as leading indicators about the underlying strength of the economy. Strategist contacts noted that economists tended to wait for, "hard data" like Industrial/Manufacturing indices and GDP data before changing their forecasts for Bank Rate. Market contacts also seem to have placed more weight on the potential impact of slower global growth and the scope for associated downside news for the UK.

Chart 4: SEF and Reuters poll expectations

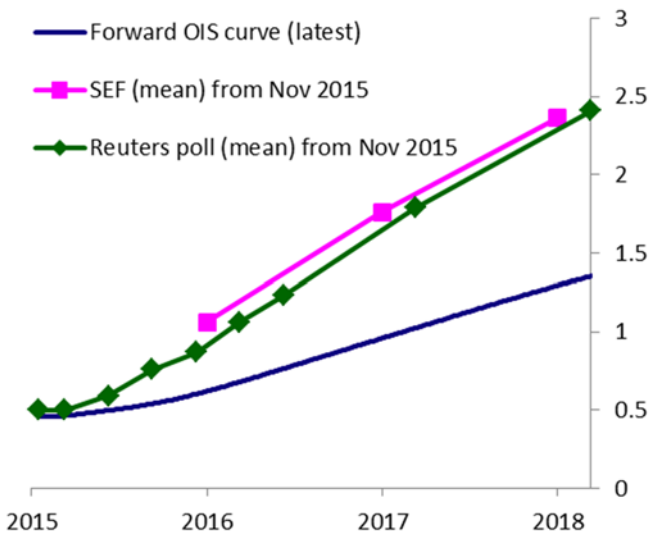
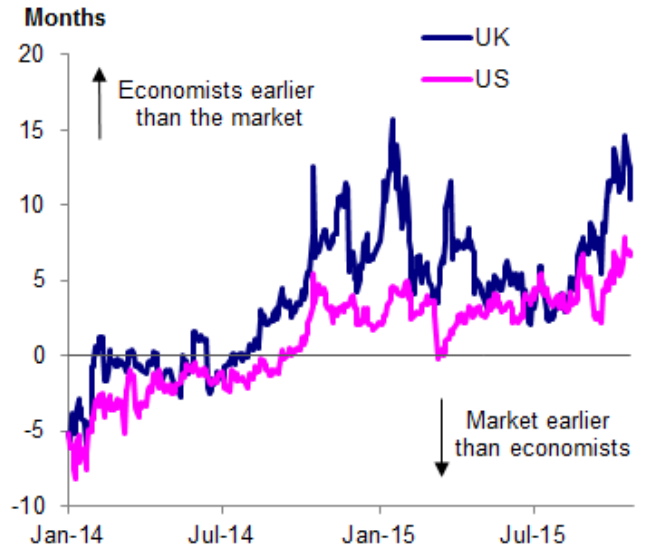


Chart 5: First rate rises: the gaps between the market and economists



Source: Primary dealers survey (US), Reuters survey (UK) and OIS

C. What do contacts expect from the November *Inflation Report*?

9. Few contacts had firm views about what the November *Inflation Report* would contain. But there are three points worth drawing out from our conversations. First, contacts are expecting further clarity from the MPC on the impact of the global slowdown on the UK economy. A minority of market contacts seemed to have pre-empted the MPC, concluding that the impact on the UK would be negative – taking their cue from the FOMC's reaction function in September. But others are waiting for more information, not least given the October MPC Minutes which suggested the *IR* would be an opportunity "to reassess the accumulated evidence regarding the international environment in full".

10. Second, they expect that the *Inflation Report* will prompt some reaction - given the divergent views held by the market and economists. Given the gap between the views, one of these camps will be proved 'wrong' in some way, and will have to adjust accordingly.

11. Third, they implicitly think that the market will be proved right - contacts generally expected the additional stimulus from a much lower yield curve to be offset by a lower outlook for growth and inflation, such that the MPC would publish a similar CPI forecast to that in August (with CPI 0.1pp above target at the end of the forecast period). As a result, they expected that the MPC would broadly validate the current market curve, prompting many of the economists to reassess their projections for Bank Rate.