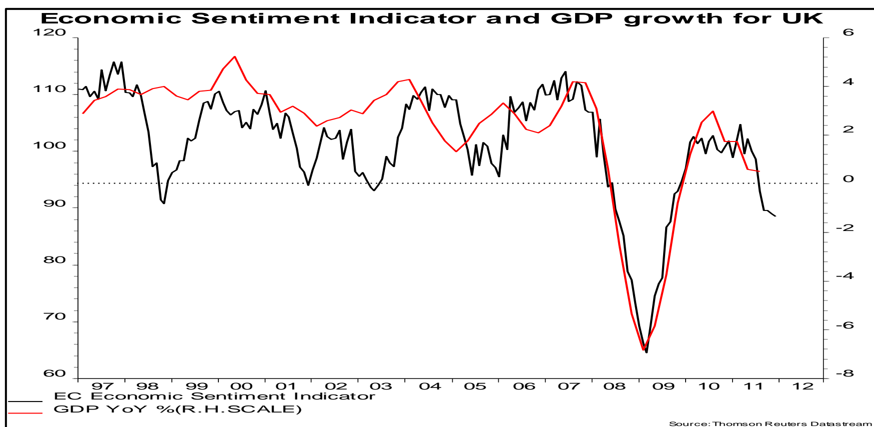
Gearing up for further QE in the UK

Wednesday 25 January sees publication of the Minutes of the last BoE MPC Meeting and the first stab at Q4 2011 GDP, factors that are likely to help frame discussion of the likelihood and timing of QE3 in the UK. Forward looking indicators continue to highlight the risk of the UK sliding back into recession (sees first chart below). As much as uncertainty surrounding events in EMU may have weighed on sentiment, domestic fundamentals are still hardly that supportive; far from it. Real wages remain negative (more on this later), credit conditions tight and labour market statistics suggest that fiscal tightening is becoming more evident.

One of the most convincing arguments in favour of QE3 is the MPC's detailed projections for inflation following the 6 October decision to purchase an additional £75bn of Gilts (see table below). Based on market expectations of the Bank Rate, as a "central case" the MPC saw CPI inflation falling well below target to a low of 1.21% in Q2 2013, before then rising slightly to 1.5% by Q4 2014. And, this was after announcing QE2. Arguably, one of the more striking aspects of the MPC's November 2011 inflation forecasts is that there was no difference between their numbers for the mode, median or mean, although that implied that they then saw almost a 45% chance of inflation being below 1% in the middle of 2013 and a 50% probability of inflation being below 1.5% in Q4 2014.



BoE CPI inflation projections based on market interest rate expectations and £275 billion asset purchases from November 2011 Inflation Report

	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
Mode	4.71	3.43	2.96	2.46	1.72	1.33	1.21	1.22	1.27	1.32	1.35	1.42	1.5
Median	4.71	3.43	2.96	2.46	1.72	1.33	1.21	1.22	1.27	1.32	1.35	1.42	1.5
Mean	4.71	3.43	2.96	2.46	1.72	1.33	1.21	1.22	1.27	1.32	1.35	1.42	1.5
Assumed Bank Rate	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.8	0.9	1	1.1	1.2
Probability that distribution will be above or below particular values													
Pr. < 1.0%				12%	29%	40%	44%	44%	43%	42%	41%	39%	37%
Pr. 1.0% - 1.5%			6%	10%	14%	14%	14%	14%	13%	13%	13%	13%	13%
Pr. 1.5% - 2.0%			10%	13%	15%	14%	13%	13%	13%	13%	13%	13%	13%
Pr. 2.0% - 2.5%		9%	15%	15%	14%	12%	11%	11%	11%	11%	11%	11%	12%
Pr. 2.5% - 3.0%		17%	18%	15%	11%	9%	8%	8%	8%	8%	9%	9%	9%
Pr. > 3.0%		69%	49%	34%	17%	11%	10%	11%	12%	13%	14%	15%	16%

Source: Bank of England

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So, even with QE2 the MPC saw as a "central case" inflation being well below target over the horizon that policy is targeting. And, since then the ONS have confirmed that CPI inflation fell to 4.67% in Q4 2011, broadly in line with what the November Inflation Report expected.

And, today saw buried within the retail sales release a further decline in the retail sales deflator, of 1.2% in December. This represents the biggest December discounting since 2008 taking the year-on-year change in the retail sales deflator down to 2.4% from 3.6% in November and August's peak of 5.2% and the lowest figure recorded since November 2009.

Moreover, as ever the MPC's forecasts of inflation would have been predicated on their perception of what was likely to happen to the output gap, which in turn is partly a function of what will happen to GDP growth. Despite the MPC significantly revising down their GDP estimates (it was not so long ago, in 2010, that an Inflation Report suggested that the UK economy would experience the strongest recovery on record), arguably the risks around the MPC's projections for GDP remain skewed on the downside.

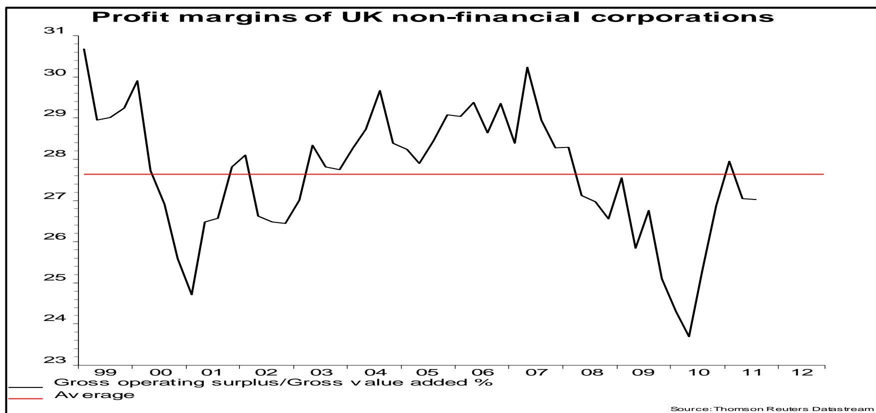
Q4 2011 GDP has yet to be published, but back in November the MPC's central case was that the UK would grow by 0.92% on average this year, 2.76% in 2013 and 3.32% in 2014. This compares with the OBR's numbers of 0.7%, 2.1% and 2.7%. But, taking on board the risk that UK GDP declines somewhat in Q1 2012 after say a 0.1% fall in Q4 2011 (the consensus call) then the most likely outturn is probably that the economy basically records no growth at all this year. And, this is even assuming a second half UK recovery.

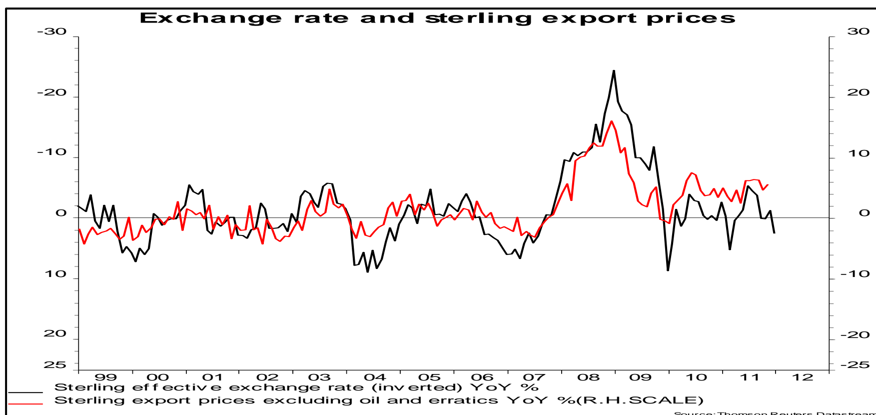
Of course, the biggest open risk is an EMU break-up that causes contagion to spread and trade credit to dry up, causing UK GDP to collapse again. Understandably perhaps, the MPC may not want to consider this scenario as part of its published numbers (certainly, it would probably not wish to assign a probability to it, for the attention it would likely get), but clearly it has to be discussed at a policy level and would elicit a policy response. An EMU break-up would not just require liquidity being pumped into the banking system. If UK GDP were to collapse then logic would dictate there should be some form of substantial policy easing. With the Bank Rate at 0.5% and the BoE having bought £275bn of Gilts, what happens next?

A further complication would be if sterling were to rise significantly, partly on the back of the UK being viewed as a relative safe haven. So, when examining the detailed spread sheets that go along with the fan charts in the Inflation Report (not that the actual tables will be published until the February Minutes are released, a week or so later), it is important to recognise that any true "mean" MPC estimate for both GDP growth and inflation could be significantly lower than suggested by the published MPC figures. Despite from a market standpoint, risk being currently back on the table, an EMU break-up remains the big elephant in the room as far as policy is concerned, perhaps best talked about only in private. Furthermore, as far as financial stability is concerned, the buck now stops with the Governor. Arguably this will make it even more likely that the BoE is more sensitive to financial conditions than was the case running into 2007 and 2008 (when financial stability fell within the various orbits of the FSA, Treasury and BoE). In the current environment this might further tilt the argument towards an easier monetary stance than was the case when for a time in 2008 when moral hazard was perhaps the bigger concern.

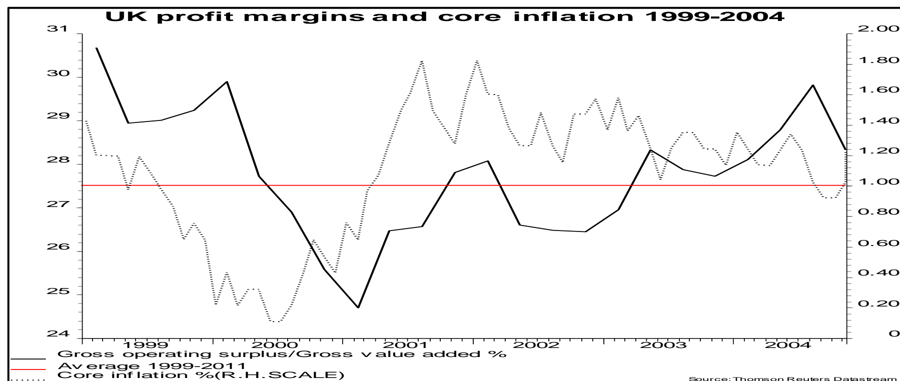
Examination of the November Inflation Report suggests that one of the concerns of the MPC was a corporate sector that could act to rebuild profit margins, making it less likely inflation falls or stays below target. At a retail level this does not seem to be borne out by the latest numbers, but clearly domestic margins, in particular came under enormous pressure in the downturn. In their last Inflation Report the BoE showed a macro proxy for margins, the gross operating surplus of non-financial corporations to gross value added. But, because the ONS does not release a quarterly series for gross value added, or turnover, of non-financial corporations, effectively the BoE showed an estimate of the profit share to GDP. However, at turning points in the economic cycle this can be misleading, because gross value added or turnover of companies initially tends to fall more than GDP, before recovering more sharply.

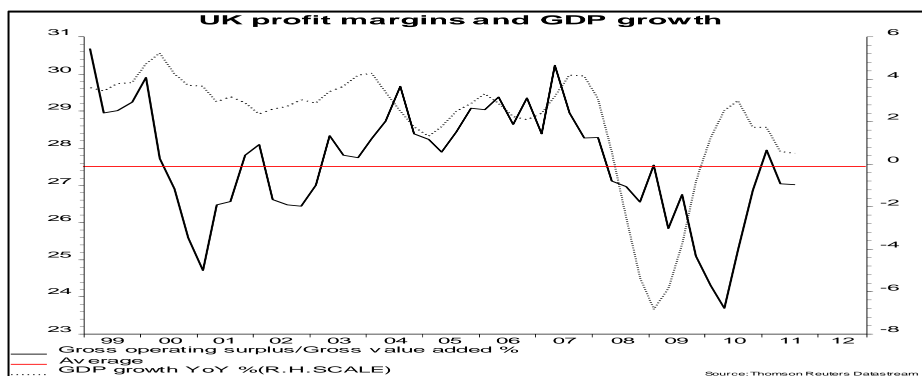
So, we have included a chart below that makes use of the ECB/Eurostat estimate of gross value added of non-financial UK corporations on a quarterly basis (which we suspect is based on the ONS's annual data). Profit margins on this measure are not so far below their long-term estimate, but as the BoE rightly argued in their November Inflation Report, this has been flattered by the ability of UK exporters to raise margins, on the back of a weaker sterling (see second chart below). As we have consistently argued, UK exporters typically price to market, so when faced with a weaker sterling, simply raise margins by effectively doing nothing. The corollary of this is that domestic margins of many companies are still likely to be standing at historically relatively depressed levels.



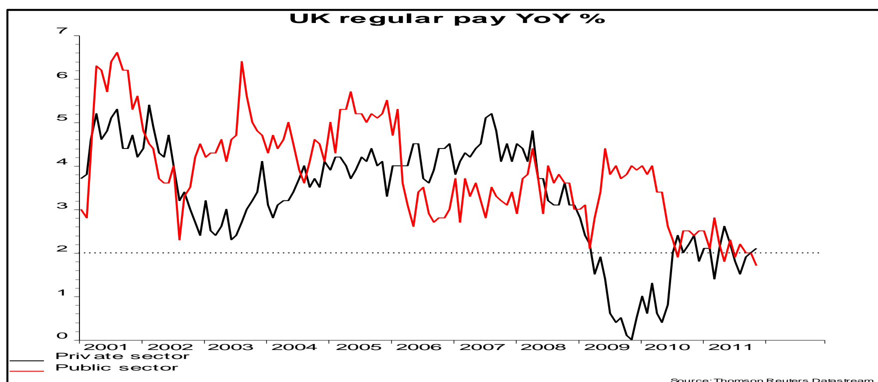


Of course, go back to 2000 and 2001 and one can find a period when a rise in core inflation in the UK preceded an improvement in profit margins from previously historically low levels (see first chart below). But, that was a very different period when there was a large output gap in the UK and GDP growth was relatively robust (see second chart below). If UK GDP now turns down, profit margins will come under pressure again and arguably without the benefit of a weaker exchange rate to help boost them (although please note this is at a macro level, what happens to quoted UK margins and earnings can be very different).





Moreover, latest labour market statistics contained a further moderation in wage pressure in the UK with so-called regular pay rising at 2% or below (see chart below). Inflation expectations may be adaptive and did pick-up on the back of higher headline inflation, but clearly this did not feed through to the labour market. If the MPC is right, then inflation expectations could fall significantly next year. This would particularly be the case if the economic outlook worsens and GDP turns down.



As far as QE is concerned, we would make a number of points.

First, we think 2012 will be a year of competitive QE, with the Fed buying MBS (please see Ward McCarthy and Thomas Simons' notes on the subject) and the ECB moving to full-blown QE after it has hit the zero bound for the policy rate, say the late spring. In the absence of additional QE in the UK, the risk is that sterling rises on the foreign exchanges representing a tightening in UK monetary conditions.

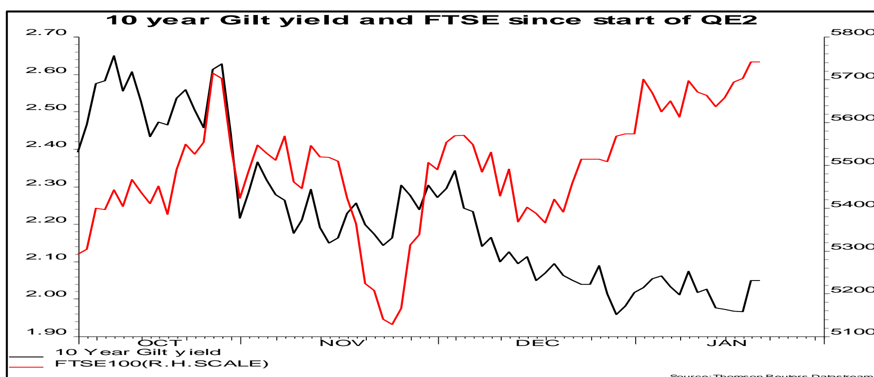
Second, we would argue that QE3 to some degree is already in the price. It may be far from fully discounted, but in general market participants are pricing in something for a further policy response from the BoE.

Third, some of the discussion about whether it is the outstanding stock of Gilts purchased or the Gilt purchases themselves that matter for the shape and the level of the yield can miss the bigger macro picture, as far as the economy is concerned. Even if, everything being equal, Gilt yields were not to rise following a pause/ending in QE, arguably as far as GDP growth and ultimately inflation is concerned, it is changes that matter. If QE represents a policy easing then ultimately the boost given to the wider economy will eventually fade once Gilt purchases come to an end. QE may operate with long and variable lags, but ultimately the pulse from the policy easing fades.

Of course, the big hope has been that by then the recovery will have grown legs, such that further policy easing is not required and the BoE can eventually think about taking some of the accommodation off the table. But, this view of the world continues to be overtaken by a sequence of unexpected and unfortunate events. And, meanwhile it should not be forgotten that fiscal policy is in the process of being tightened significantly.

As ever, policy remains path dependent. The only question though at the moment from our perspective is whether the MPC announces a further dose of QE at the February Meeting, or decides for now to keep its powder dry. For one thing the situation in Europe remains very fluid. But, Wednesday's Minutes and Q4 2011 GDP release will help us better assess the odds.

Finally, there is a view that QE2 may have less (proportionate) impact on the wider economy than QE1, and that QE3 would have less impact than QE2. That may be true. But, that in itself would not argue against doing QE3 if it was still seen as having a positive effect.



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