16 December 2021
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Investment Event

BoE raises rates as ECB tapers

At the Bank of England's (BoE) December meeting, the policy rate was raised to 0.25% in a surprisingly hawkish 8-1 vote

Bank of England raises Bank Rate by 15bps

The Bank of England's (BoE) Monetary Policy Committee (MPC) raised the UK policy rate (also known as "Bank Rate") by 15bps to 0.25% at its December meeting, contrary to economist expectations for the MPC to remain on hold. In addition, the MPC maintained its target for holdings of government bonds at GBP875bn and corporate bonds at GBP20bn, as expected. The committee voted 8-1 to raise rates with only Silvana Tenreyro voting against the majority.

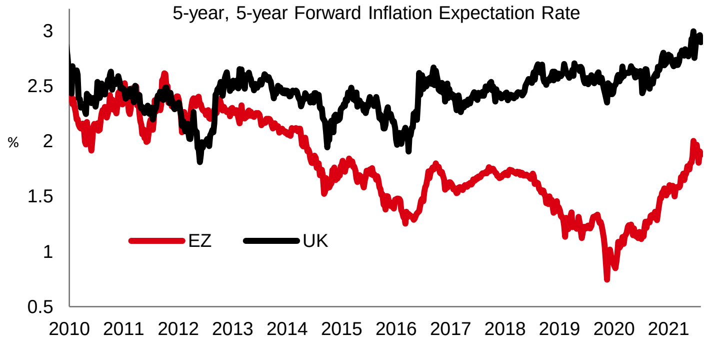
In November, the MPC teed up a rate hike "in the coming months" providing the economy evolved as it expected. Since then, inflation and labour market tightness have surprised to the upside. On inflation, year-on-year CPI has risen to 5.1%, above the Bank's forecast for a peak of around 5%, which it has now revised to 6%. Meanwhile, the labour market has recovered at a faster-than-expected rate with little sign that the closure of the furlough programme led to a weakening of the labour market. The MPC now sees the unemployment rate falling to 4% by end-2021, versus its forecast of 4.2% in November.

In addition, inflation expectations (Figure 1) have become a worry for the MPC as inflation has continued to rise, with job-to-job moves at record highs and evidence that salary increases are reaching uncomfortable levels, risking a wage-price spiral.

Inflation expectations have become a worry for the MPC

However, the Bank does see near-term risks to the economic outlook from the Omicron Covid variant, but it stopped short of seeing this as a key risk to inflation, citing that "successive waves of Covid appear to have had less impact on GDP", whilst the medium-term impact remains highly uncertain.

Figure 1: Inflation expectations



Meanwhile, the European Central Bank (ECB) announced its 2022 taper strategy

Past performance is not a reliable indicator of future performance.

Source: Bloomberg, HSBC Asset Management, as at 16 December 2021.

Meanwhile, ECB sets out taper plans for 2022

The European Central Bank (ECB) kept the Deposit Facility Rate unchanged at -0.50% but announced adjustments to its two asset purchase programmes heading into 2022.

Despite lower asset purchases next year, policy should remain more accommodative than the BoE's, as inflation falls below target

The ECB confirmed that the Pandemic Emergency Purchase Programme (PEPP) would continue with net asset purchases until the end of March 2022 but at a lower rate than the current EUR65bn per month. After March, monthly purchases under the Asset Purchase Programme (APP) would increase from its current level of EUR20bn to EUR40bn in Q2 2022 before falling to EUR30bn in Q3 and then back to EUR20bn in Q4.

Today's announcement of tapering was largely expected amid continued economic recovery. Nevertheless, despite lower asset purchases next year, the ECB is still likely to absorb a high share of newly issued member state debt as government borrowing is expected to fall.

It is also important to note that the ECB's policy stance remains flexible in the face of risks posed by the Omicron variant. Net purchases under PEPP could resume if the pandemic causes new economic shocks.

HSBC Asset Management

In the press conference after the meeting, ECB President Lagarde reiterated that the central bank was 'very unlikely' to raise interest rates in 2022 despite inflation risks being tilted to the upside. The ECB's latest staff forecasts see both headline and core eurozone inflation falling back below the ECB's 2% target in both 2023 and 2024 as energy prices stabilise, meaning

Our views

Our baseline scenario of "the expansion economy" and relative valuations are consistent with a pro-risk tilt in portfolios, with a preference for global equities and Asian credits

Gradual policy normalisation and rising bond yields should favour late-cycle and value equities (e.g. Europe, Asia). But downside risks of weaker growth and/or sticky inflation means we want to balance this exposure with an allocation to defensive stocks

that the policy stance is likely to remain accommodative well into 2023 at the earliest. Unlike in the UK, eurozone inflation expectations remain within recent historical ranges despite the recent bout of price pressures (Figure 1).

Investment implications

For the time being, our baseline scenario remains for monetary policy normalisation to progress in a gradual manner as economies move through the expansion phase of the economic cycle. From late Q1/early Q2 2022, we expect the demand-supply imbalances in key sectors to begin improving and prices pressures to start moderating, such that inflation ends 2022 much closer to target.

We think a favourable growth/inflation mix in 2022 and relative valuations are consistent with a pro-risk tilt in portfolios, with a preference for global equities and Asian credits. Gradual policy normalisation and rising bond yields should favour late-cycle and value equities (e.g. Europe, Asia).

Nevertheless, today's BoE and ECB decisions follow a number of recent central bank meetings in which policymakers have become more hawkish in light of stronger-than-expected inflationary pressures. We see this as a shift in the perceived balance of risks towards our "sticky inflation" economic scenario which involves supply-side impairment, more persistent inflation, and ultimately a requirement for faster policy normalisation.

Under this scenario, nominal and real yields on government bonds could shift markedly higher whilst rising input costs could put pressure on profit margins. To hedge against this risk, we think a balanced approach to equity exposure makes sense, with an allocation to quality, defensive growth, and inflation-linked equities.

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