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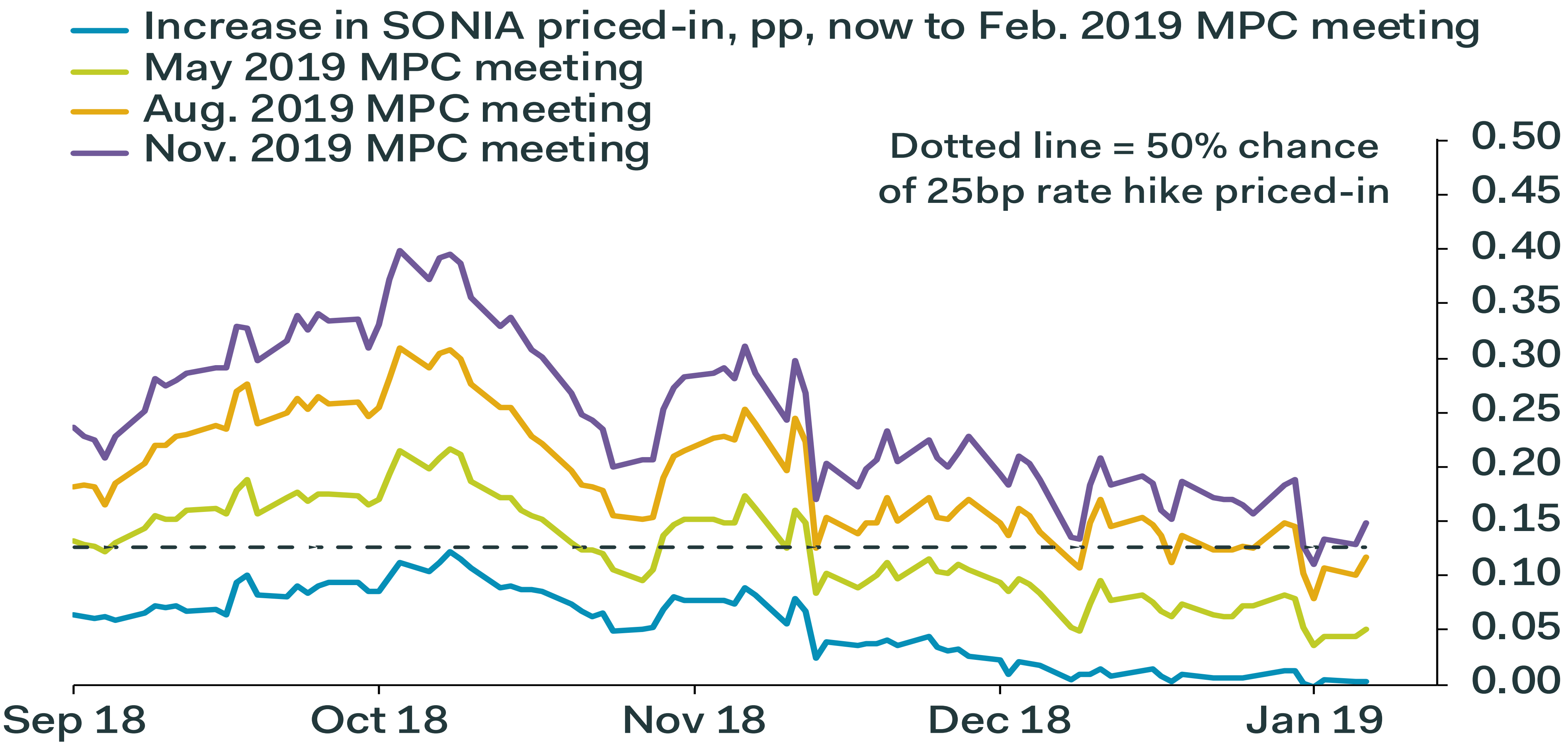
WILL BREXIT PUNCTURE THE MPC'S TIGHTENING CYCLE?

U.K. WEBINAR, 10 JANUARY 2019

SAMUEL TOMBS, CHIEF U.K. ECONOMIST
WWW.PANTHEONMACRO.COM | +44 (0)203 744 7430

1. MARKETS SEE ONLY AROUND A 50% CHANCE OF A 25BP RATE HIKE THIS YEAR



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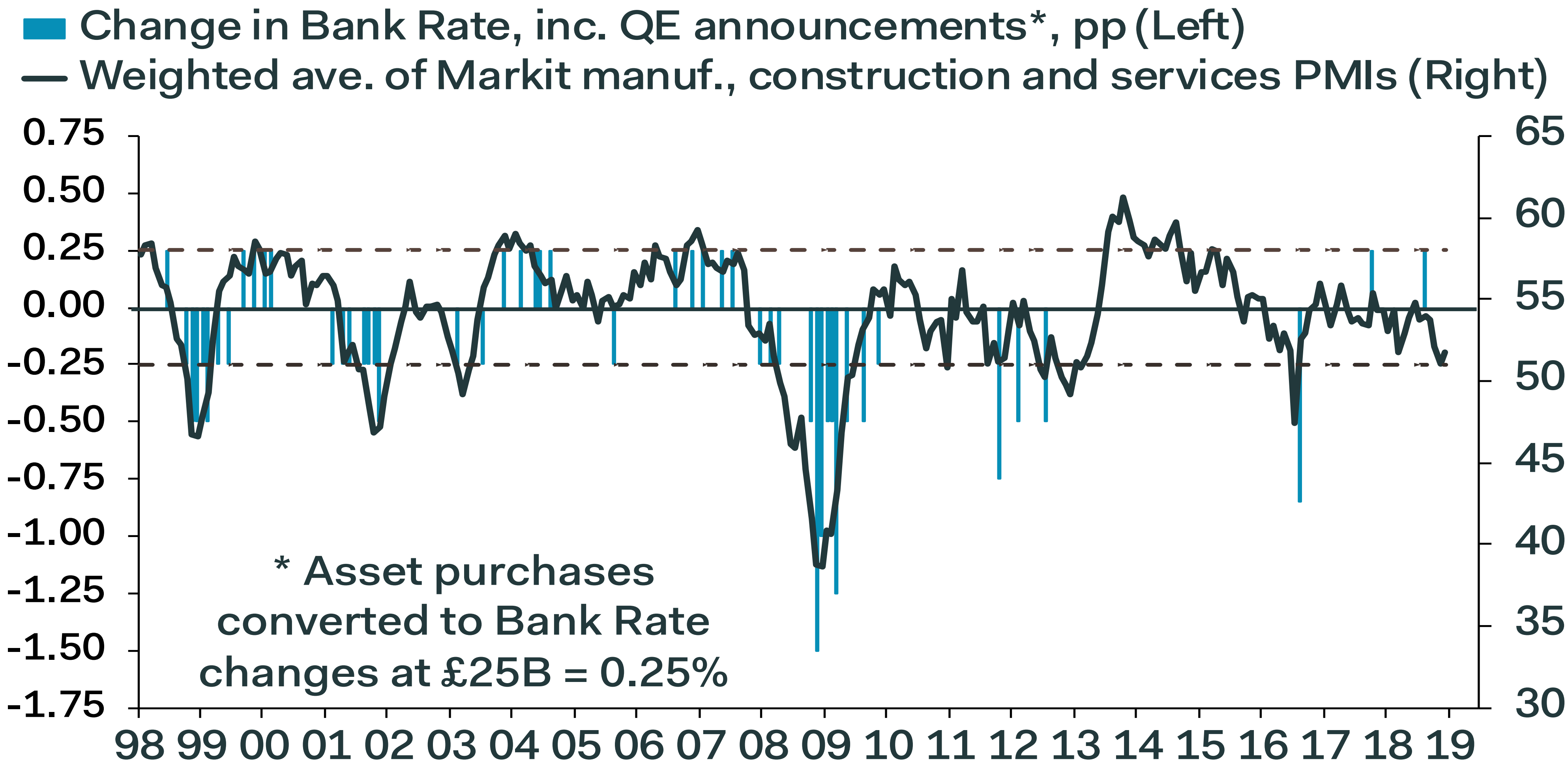
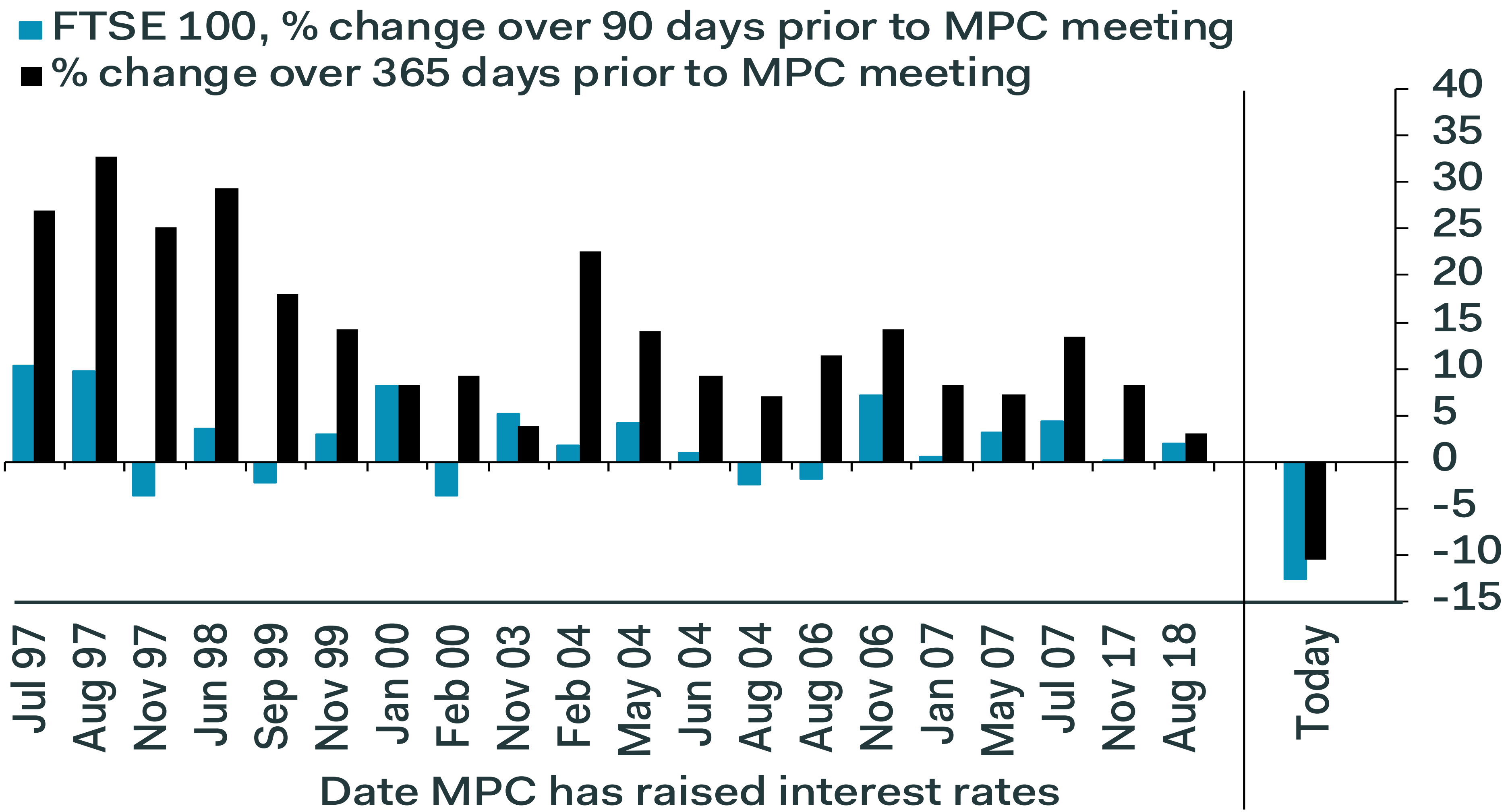
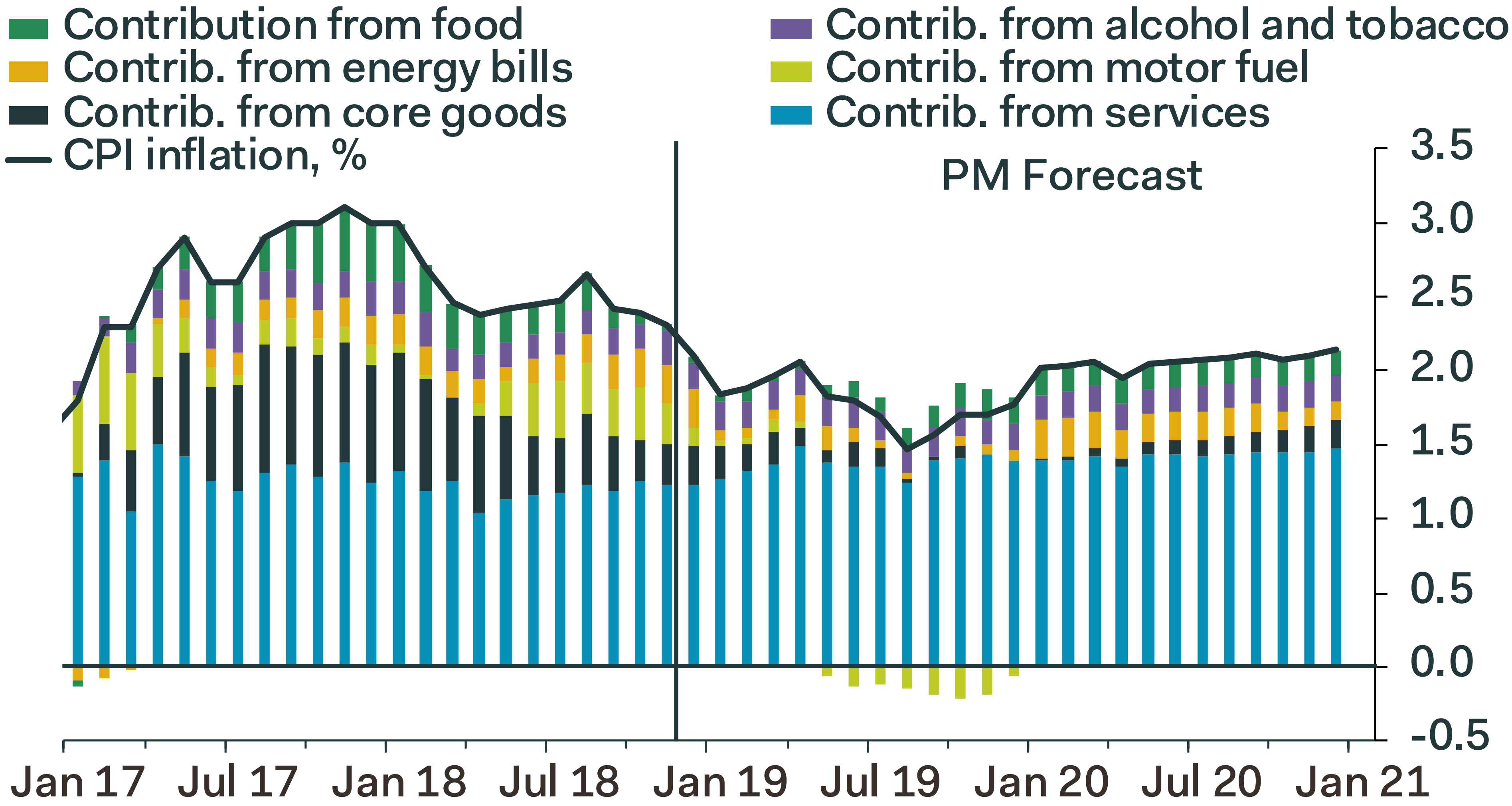
2. RIGHT NOW, THE PMIS ARE IN EASING TERRITORY; THE WEAKNESS LOOKS REAL



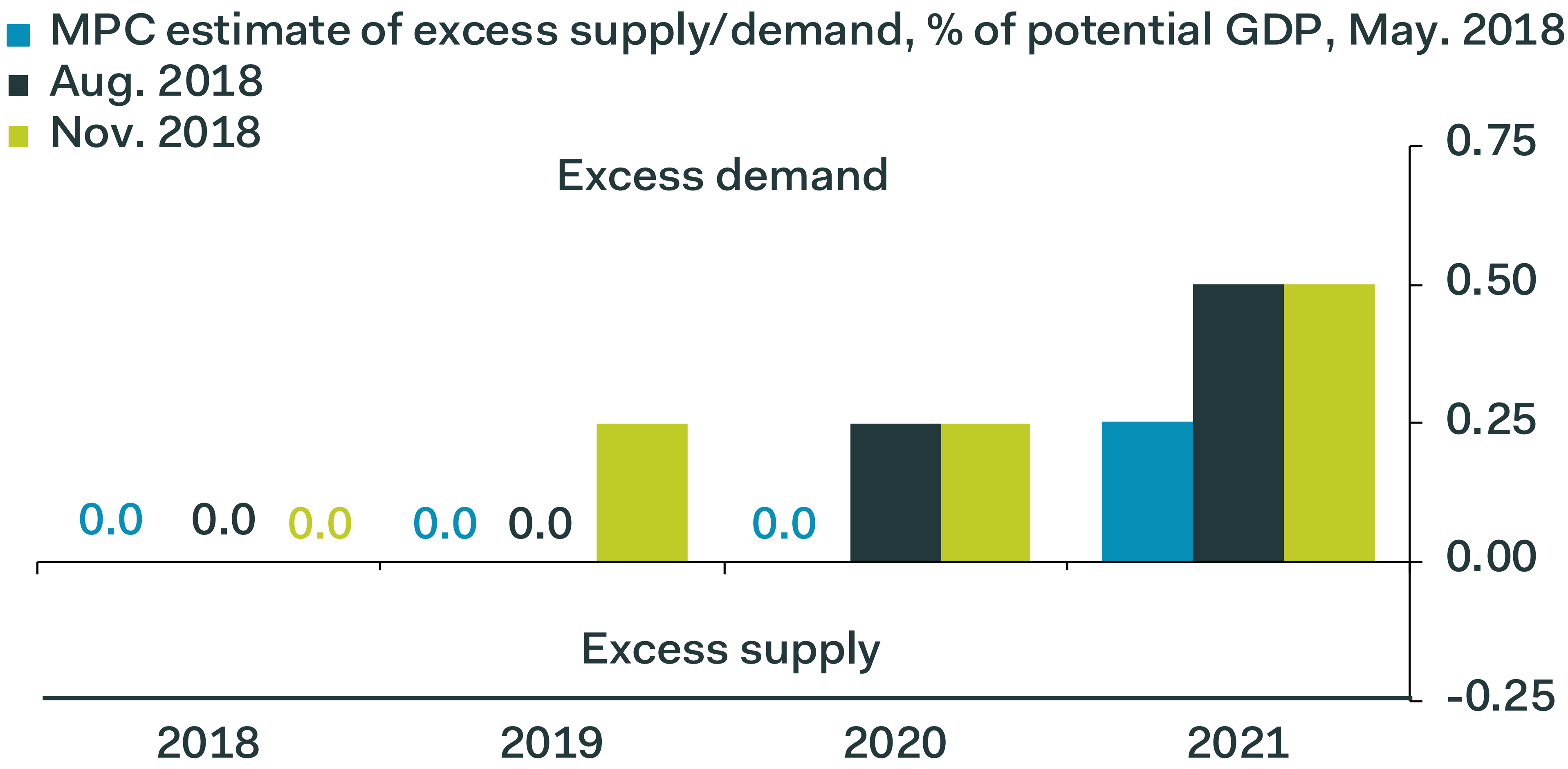
3. PAST RATE HIKES HAVE OCCURRED ONLY IN BENIGN MARKET CONDITIONS



4. INFLATION LIKELY WILL BE BELOW THE 2% TARGET THROUGHOUT 2019

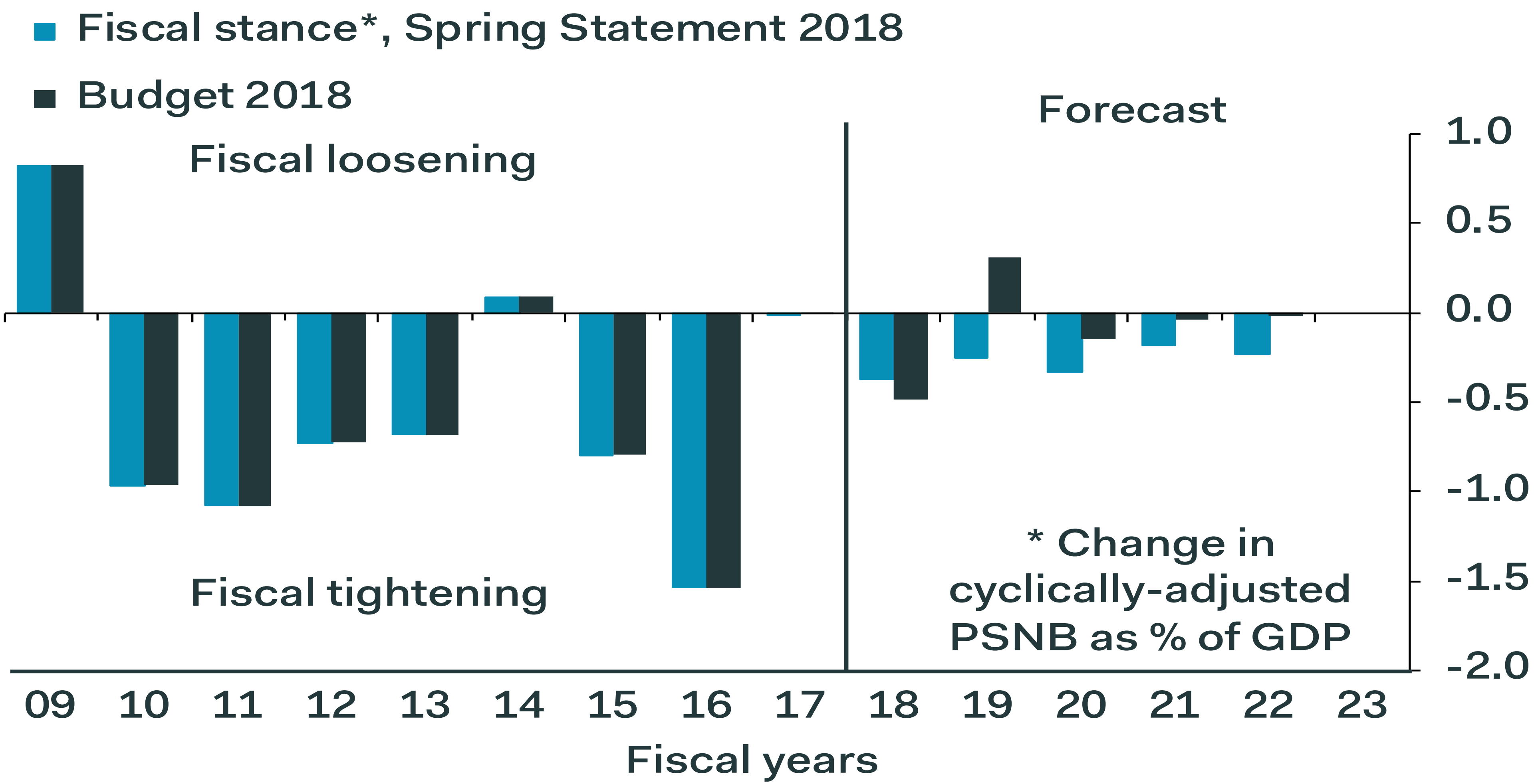


5. THE MPC, HOWEVER, BECAME MORE WORRIED ABOUT OVERHEATING LAST YEAR

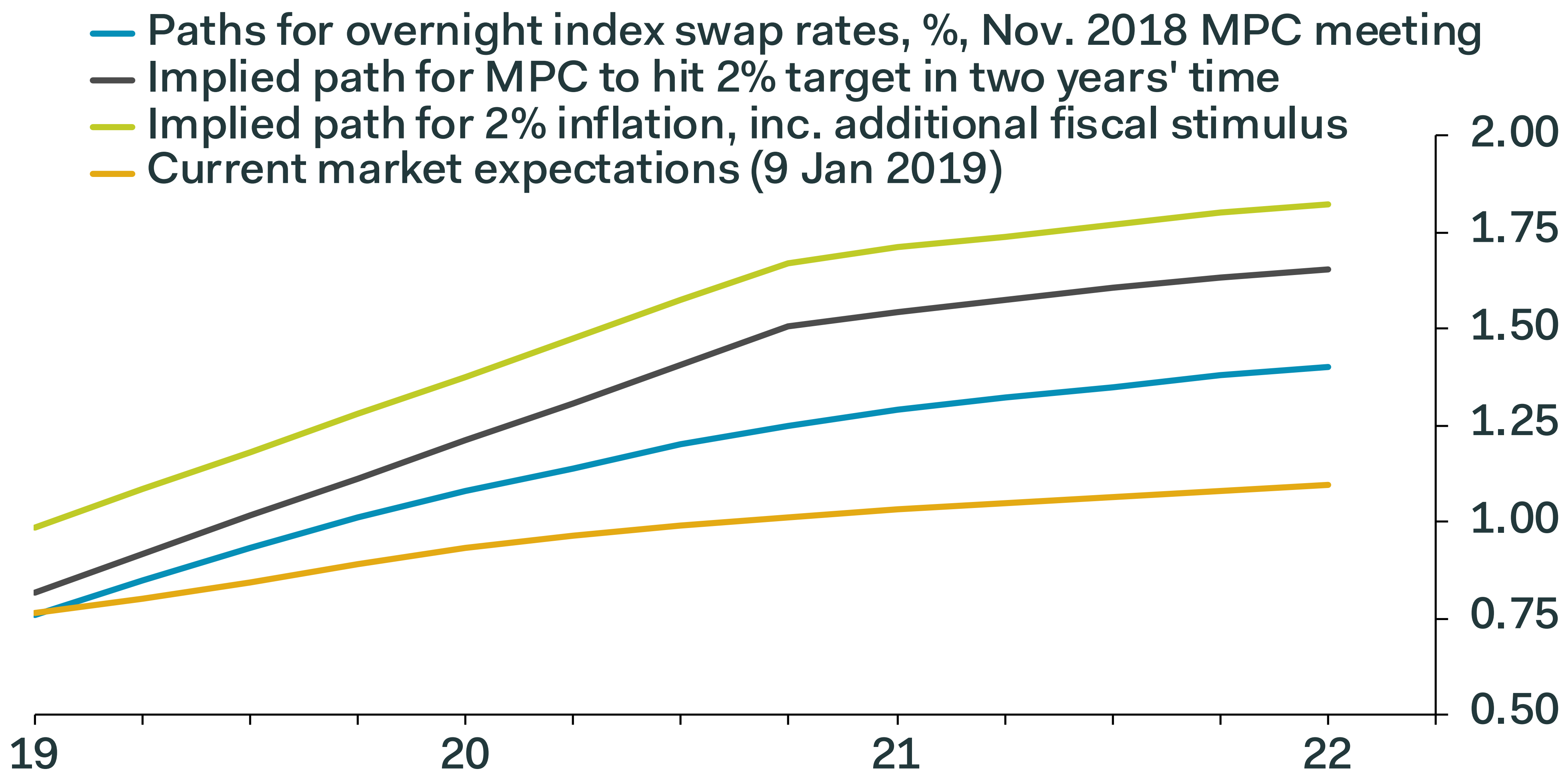


* May projections are for Q3, August and November are for Q4

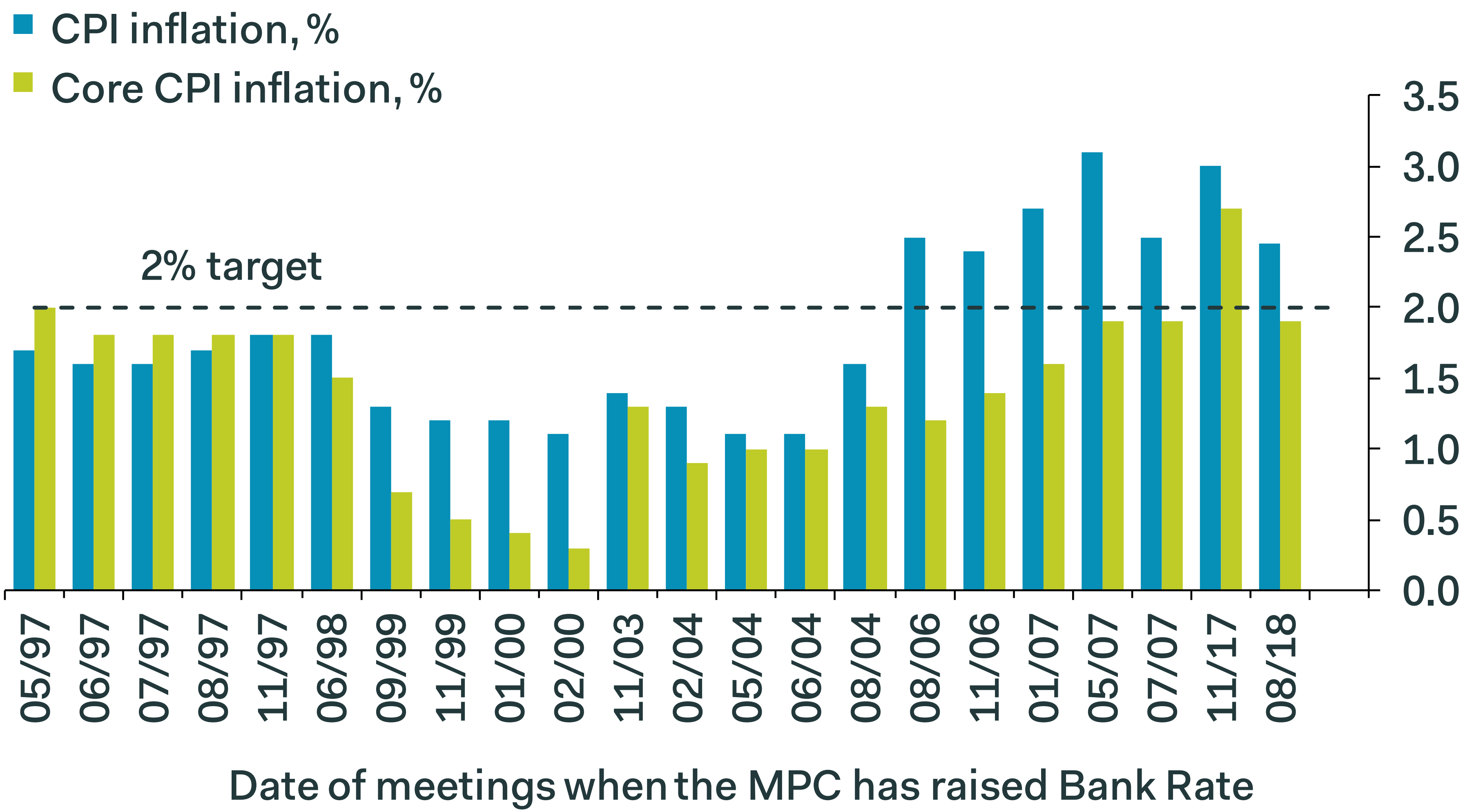
6. FOR ONCE, FISCAL POLICY IS SET TO BOOST GDP GROWTH



7. SO THE RATE PATH THE MPC THINKS IS NEEDED FOR AT-TARGET CPI IS STEEP



8. BELOW-TARGET *CURRENT* INFLATION HAS NEVER RULED OUT RATE HIKES



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9. NOT ALL DATA SURPRISES SINCE NOVEMBER HAVE BEEN TO THE DOWNSIDE

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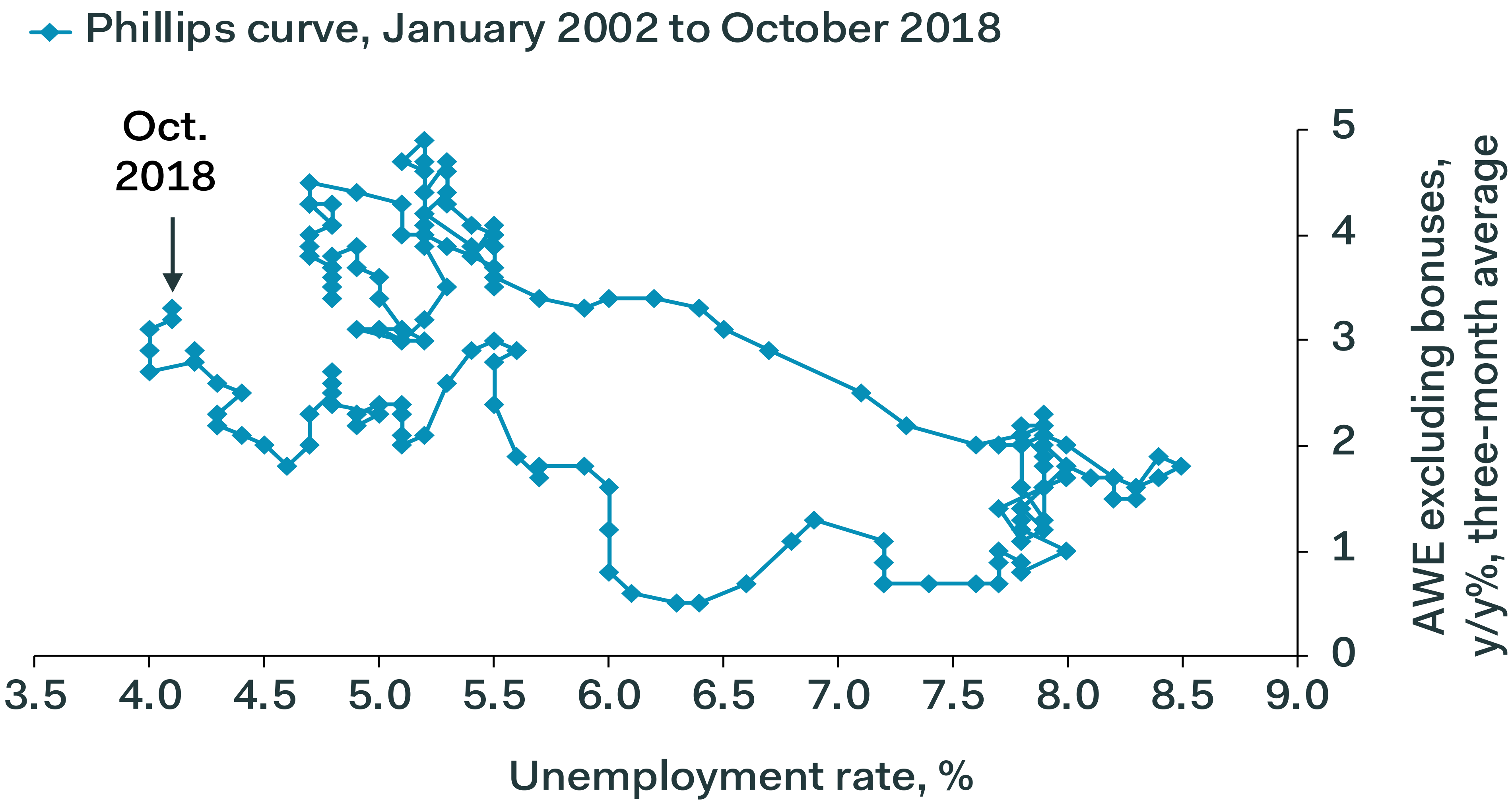
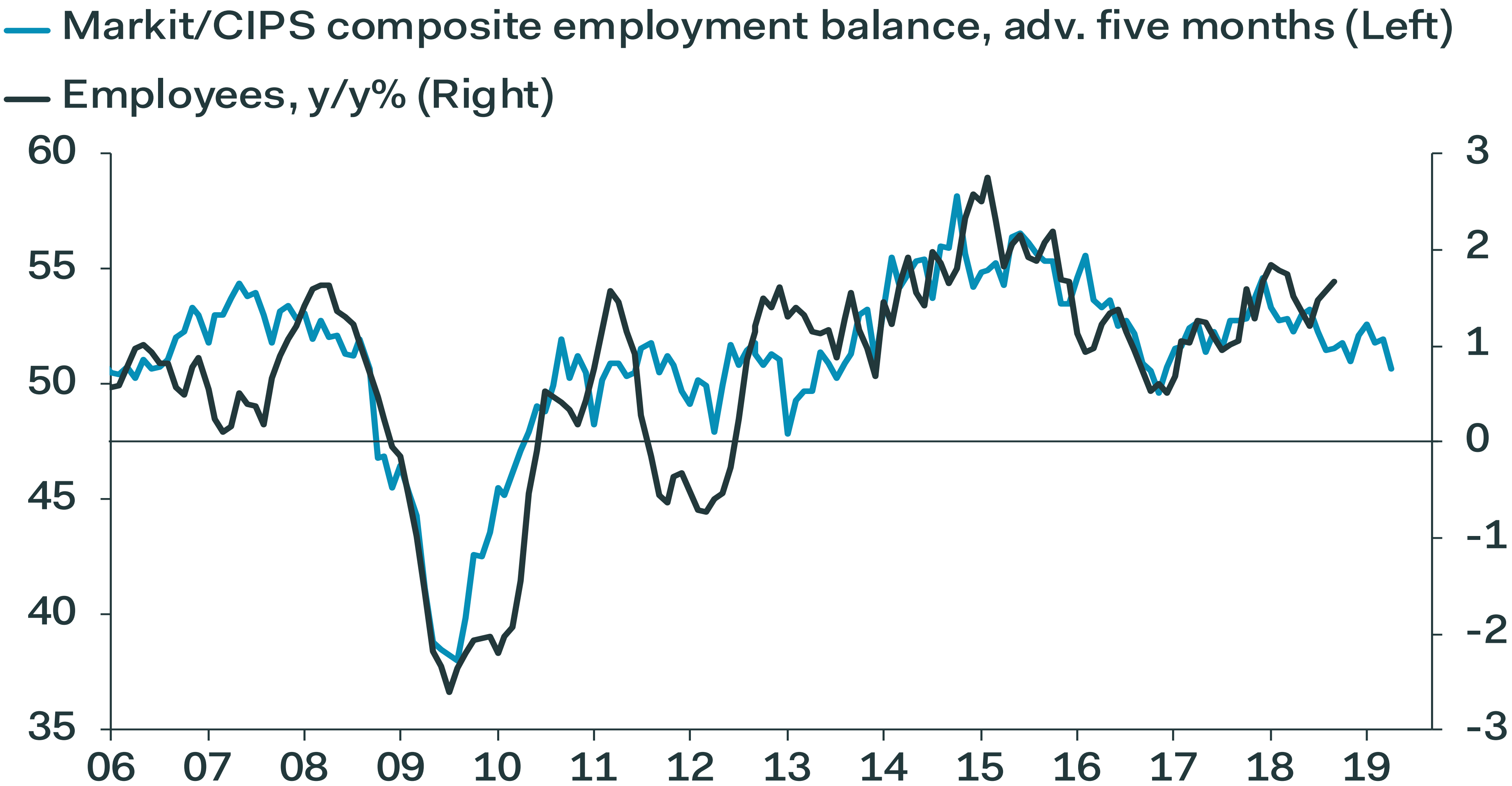
10. HAS THE U.K. SUDDENLY HIT THE STEEP PART OF THE PHILLIPS CURVE?

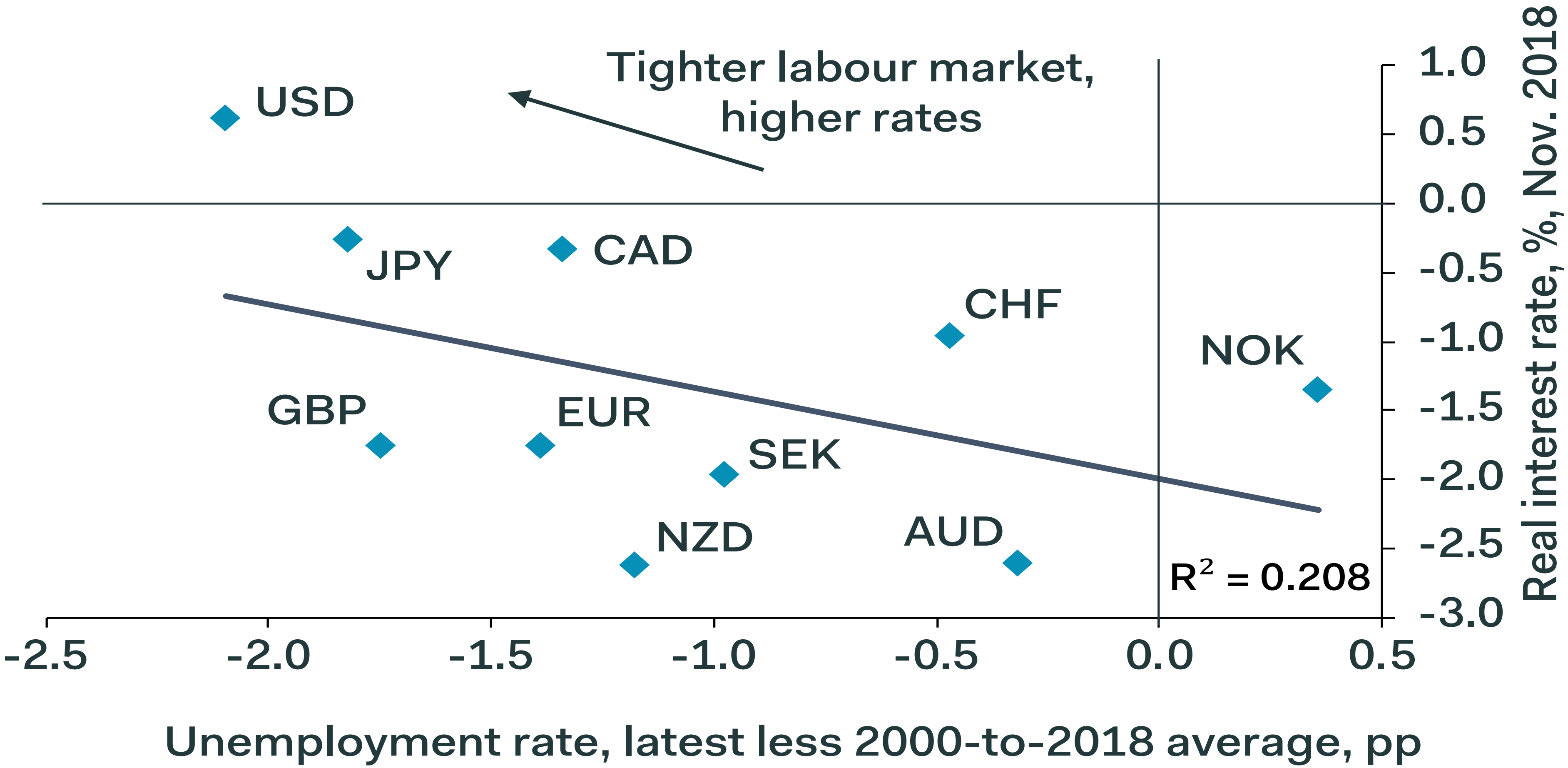


11. JOB SURVEYS HAVE WEAKENED, BUT STILL POINT TO FALLING UNEMPLOYMENT

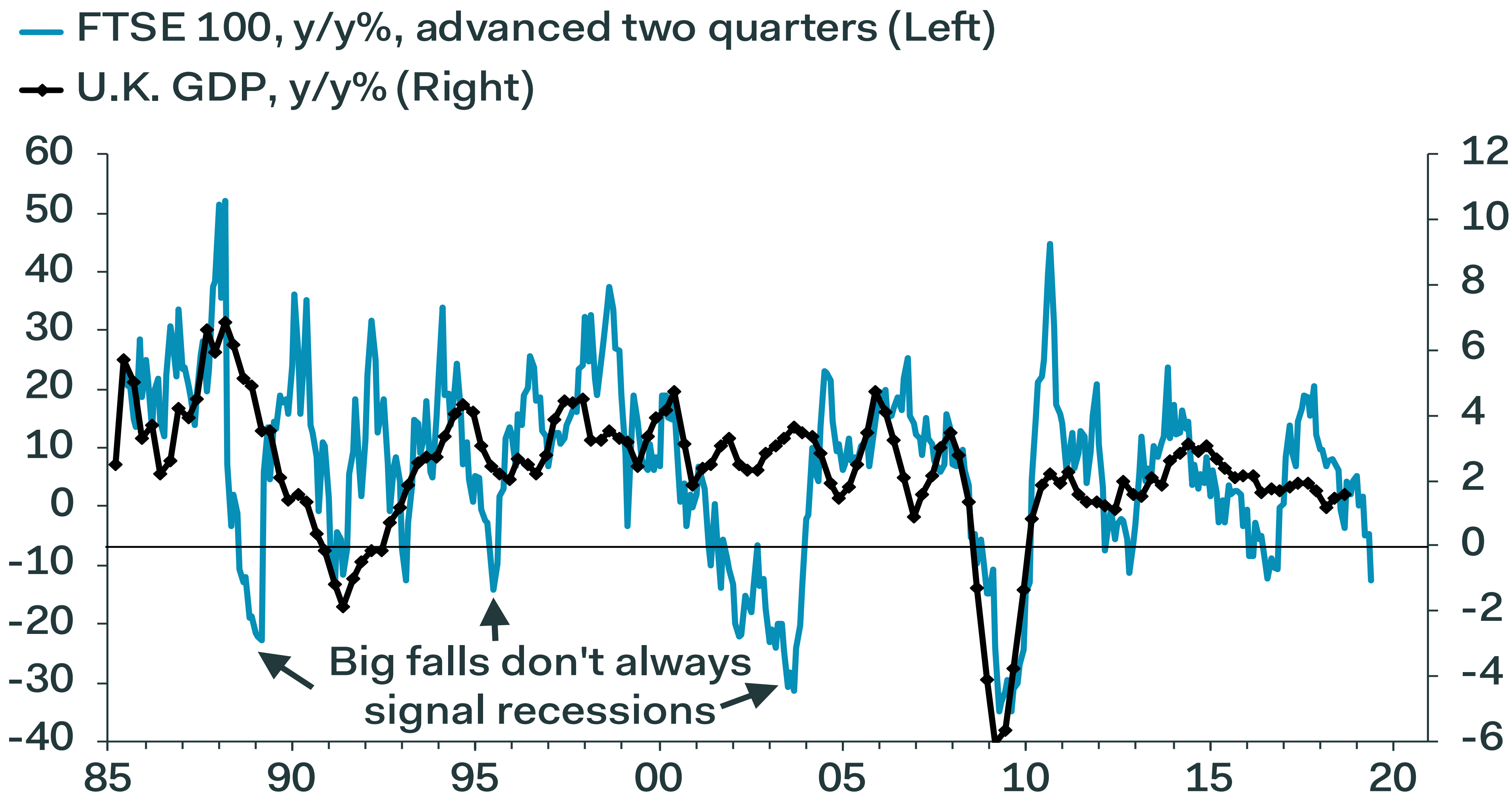


12. THE BOE ALREADY HAS BEEN MORE PATIENT THAN OTHER CENTRAL BANKS

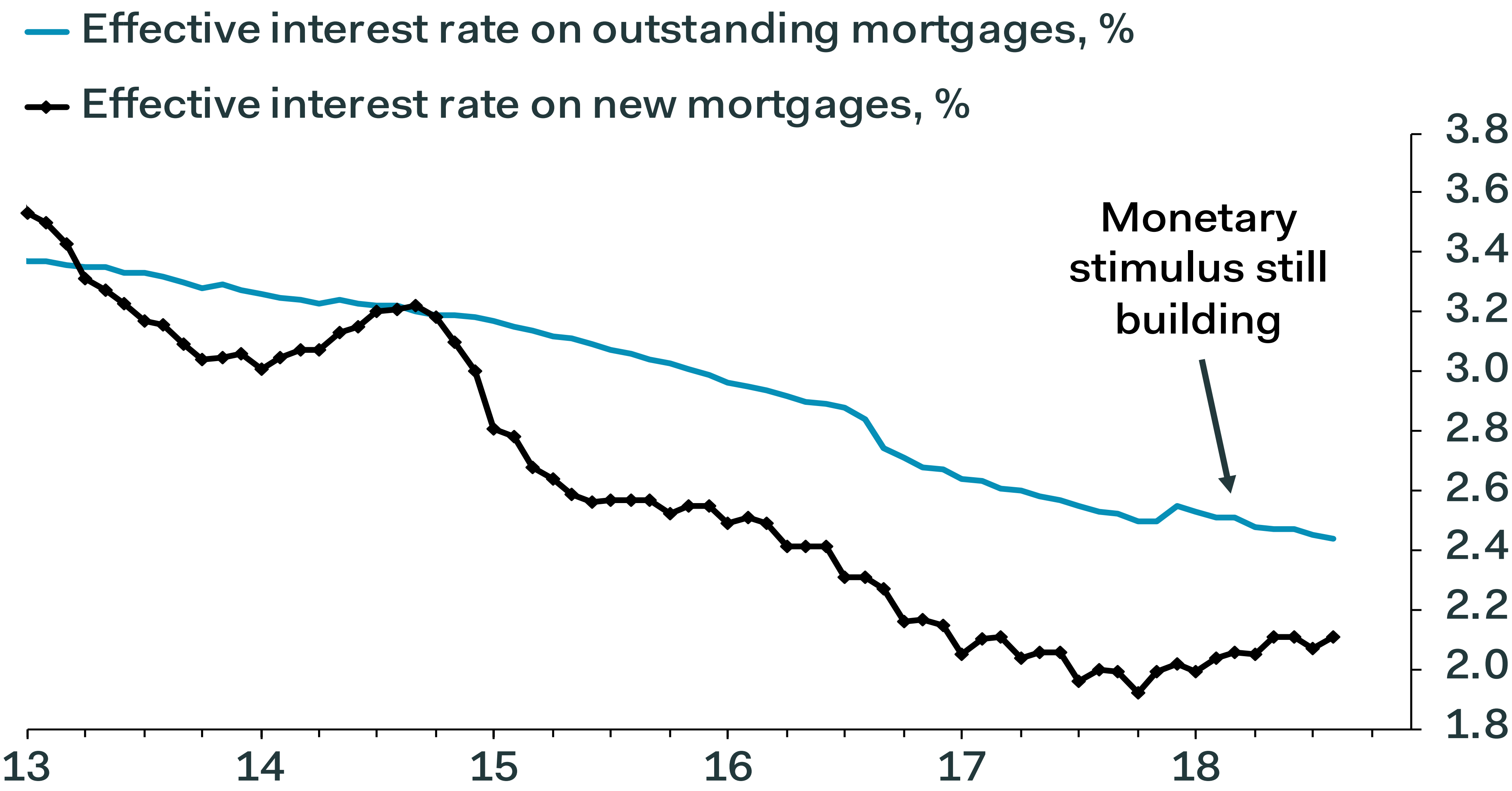
- Real interest rates and unemployment rates, G10 economies



13. THE RELATIONSHIP BETWEEN EQUITY PRICES AND GDP GROWTH IS WEAK



14. EFFECTIVE INTEREST RATES WILL KEEP FALLING UNLESS THE MPC ACTS



15. THE PM IS SET TO LOSE THE VOTE ON TUESDAY BY AROUND 100 VOTES

MPs' stated voting intentions on Withdrawal Agreement:

	All	Tory	Lab.	SNP	Lib D.	Other
For	**183**	179	1	0	1	2
Against	**420**	106	249	35	11	19
Unknown	**36**	31	5	0	0	0
Does not vote	**11**	1	2	0	0	8
Total	**650**	317	257	35	12	29

Breakdown of opposition to deal by referendum stance:

Backed Remain	**252**	22	188	32	4	6
Backed Leave	**83**	68	6	0	0	9
Was not MP/ didn't declare	**85**	16	55	3	7	4

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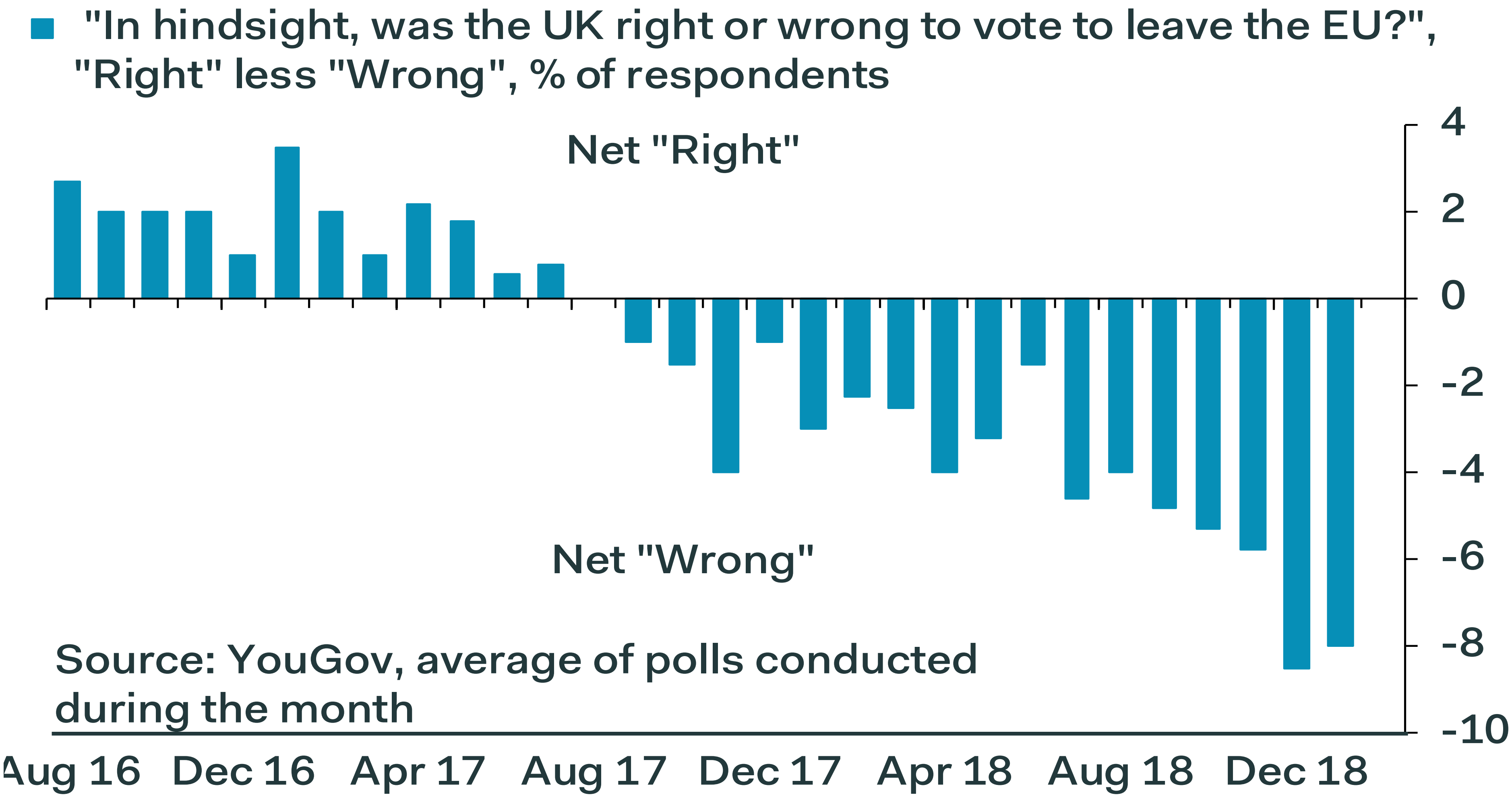
16. AN EEA-STYLE BREXIT IS THE MOST LIKELY OUTCOME

	Negotiated Brexit			Brexit reversed	No Deal, Cliff-Edge Brexit
	Parliament votes for the current deal, with minimal amendments, on January 15	**MPs vote down the current deal, forcing the PM to commit to an EEA-style future relationship to win over Opposition MPs**	**Parliament votes against the deal, general election held, Corbyn wins & softer Brexit**	**Parliament votes for a second referendum; Brexit is stopped**	**Parliament votes against this deal and future iterations**
How could this scenario happen?	Last minute "assurances" and "clarifications" from the E.U. on the Withdrawal Agreement help to bring the Conservatives together and the DUP back on side.	The government loses the vote on January 15. Mrs. May calculates that a soft Brexit is the only form that a majority of MPs would support. She presents this to parliament as her Plan B on January 21 and renegotiates the Political Declaration with the E.U.	The government is defeated in a confidence vote shortly after it loses the vote on Brexit legislation. Labour capitalises on the perceived weakness of the government in the resulting election and wins enough seats—perhaps in coalition with the SNP—to implement a softer Brexit.	The government loses votes in parliament on its Brexit legislation. Mrs. May breaks the impasse by holding a three-way referendum (no Brexit, the deal, no-deal Brexit). Alternatively, MPs only pass the legislation with an amendment requiring the public to support it in a second referendum.	No consensus in parliament can be reached. The Prime Minister is held to ransom by the DUP and Brexiteers within her party. The U.K. leaves the E.U. by default on March 29.
Obstacles	Just 183 MPs have pledged publicly to support the deal in its current form. The threat of no deal is not remotely credible, given that the ECJ has ruled that the U.K. can unilaterally reverse its decision to leave. Remainers can hold out for a better deal.	Labour MPs will seek to engineer a general election or a second referendum, before they consider voting for the deal. Ending free movement might be the one red line Mrs. May is not prepared to scrub out.	Tory rebels will back the government in confidence votes, given that opinion polls suggest the Conservatives would lose around 50 seats if an election was held tomorrow. The DUP still has a financial interest in supporting the government.	Mrs. May has clearly opposed a second referendum. Labour intends to seek another election first. Another referendum would take three months from start to finish, so article 50 would need to be revoked or the two-year period extended.	A clear majority of MPs want to avoid this outcome and will legislate to ensure it doesn't happen. The ECJ has ruled that the U.K. can unilaterally change its mind and cancel its decision to leave, thereby averting the cliff-edge.
Likelihood	15%	35% (Our base case)	10%	30%	10%
Effect on MPC	The MPC raises Bank Rate by 25bp in May and November 2019, and twice more in 2020.	The MPC raises Bank Rate by 25bp in May (provided Article 50 is not extended) and November, and twice more in 2020.	The MPC raises Bank Rate by 25bp in August, and twice in 2020. Asset prices are boosted by a softer Brexit, but undermined by Mr. Corbyn's socialist agenda.	The MPC raises Bank Rate by 25bp in August and November 2019 and three times in 2020. The tightening cycle goes further than in other scenarios, due to higher trend growth.	Inflation would jump, due to supply issues, tariffs and a lower pound. But demand would weaken too, so we think the MPC would cut rates back to 0.25% and restart the Term Funding Scheme.
$/£	March 2019: $1.33 December 2019: $1.40	March 2019: $1.35 December 2019: $1.40	June 2019: $1.35 December 2019: $1.40	March 2019: $1.38 December 2019: $1.45	March 2019: $1.15
2yr gilt*	0.90%	0.90%	1.00%	1.20%	0.20%
FTSE 100*	7,200	7,200	7,000	7,400	7,000^

17. VOTERS WOULD PUNISH A SHIFT TO A HARDER BREXIT



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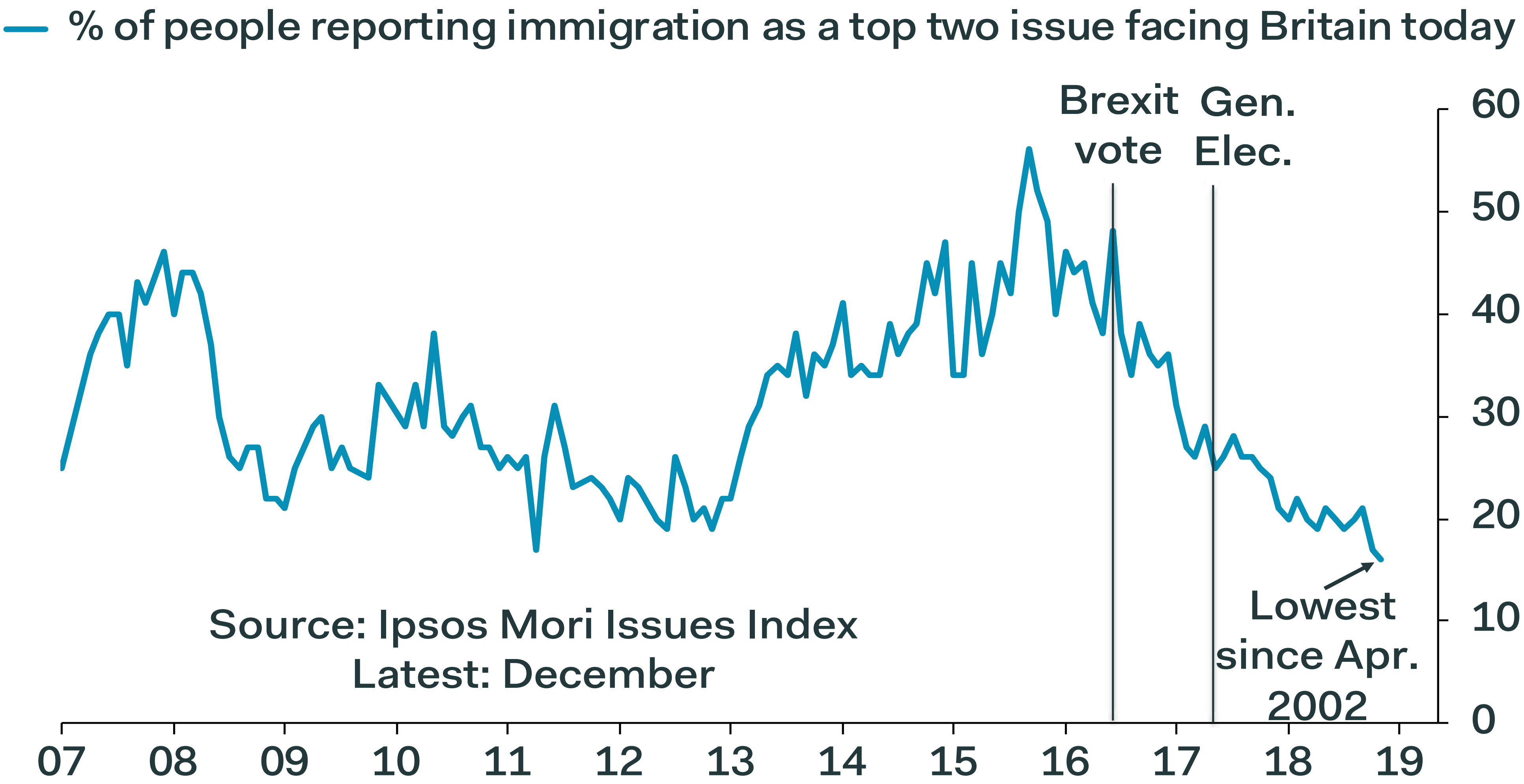
18. CONCERN ABOUT IMMIGRATION HAS COLLAPSED SINCE THE BREXIT VOTE



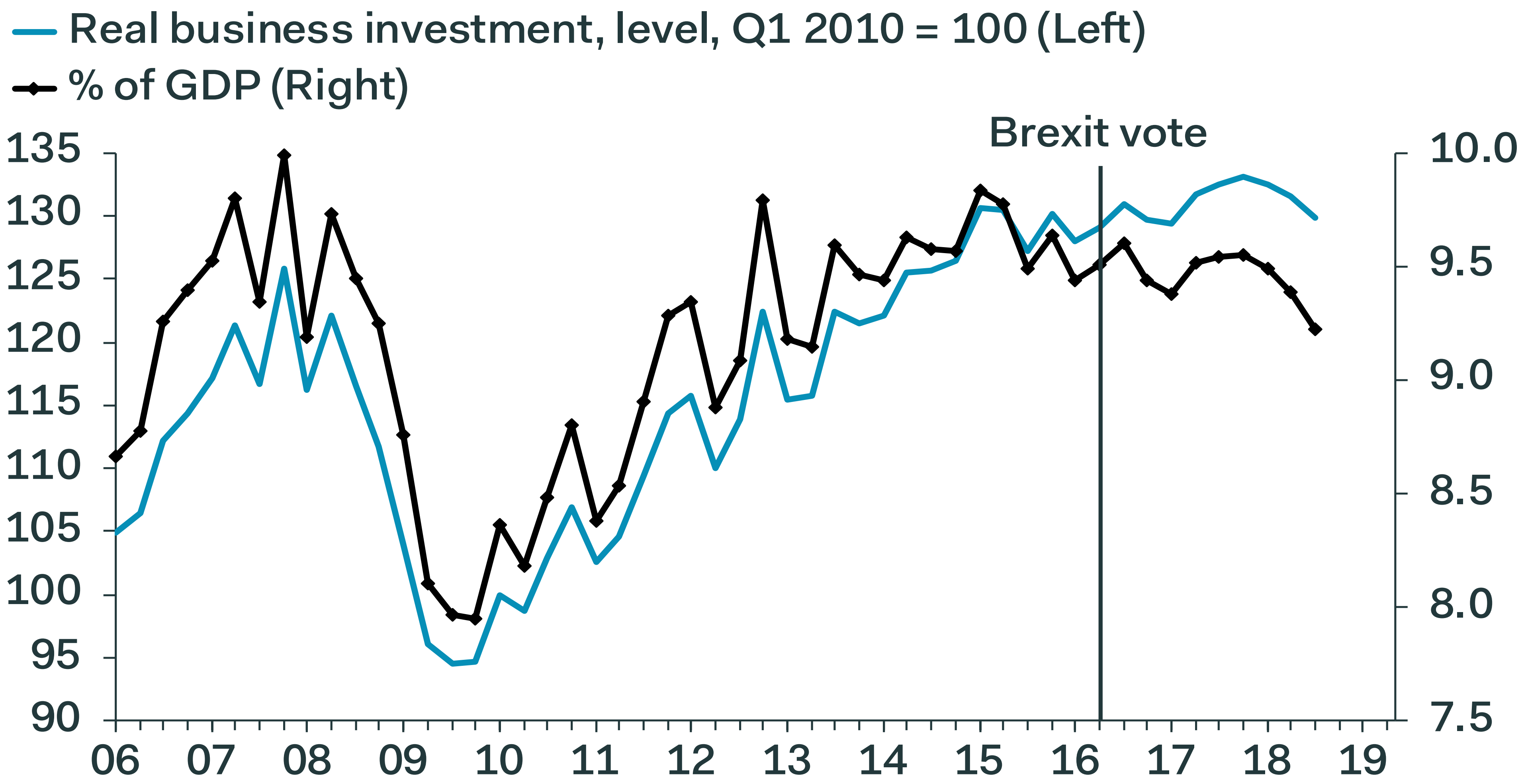
19. A SECOND REFERENDUM, REVERSING BREXIT, CAN'T BE RULED OUT EITHER

*** On paper, the government has a working majority of 13 MPs, so only seven Conservative MPs need to rebel to defeat it.**

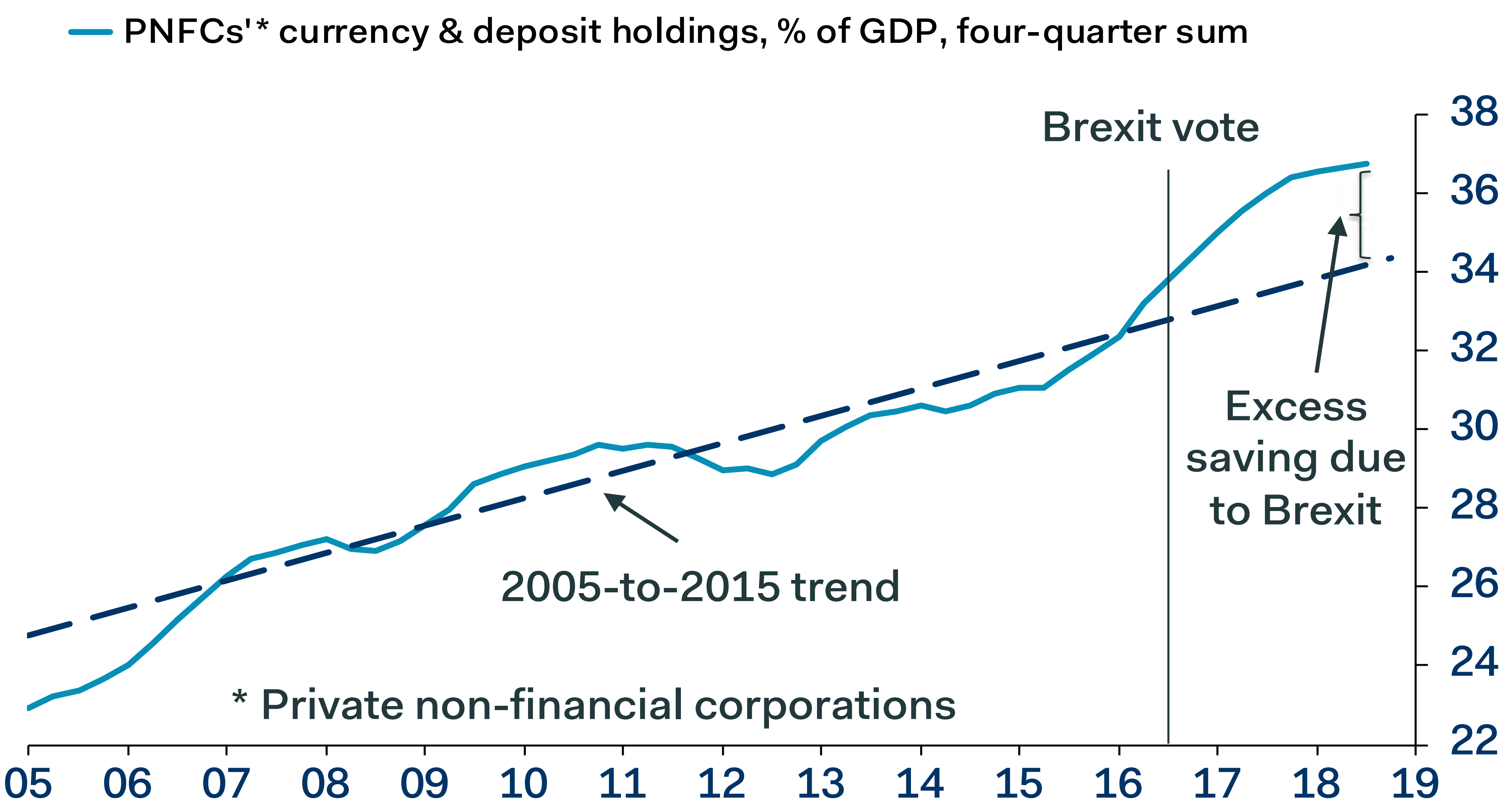
*** Ten Tory MPs currently are backing the "People's Vote" campaign. Their number might grow after the Withdrawal Agreement is voted down. A further 15 Tory MPs hold seats where more than 60% of constituents voted Remain.**

*** But a second referendum needs to become official Labour party policy to have a realistic chance of success. Mr. Corbyn will change tack only when he is convinced he can't bring down the government.**

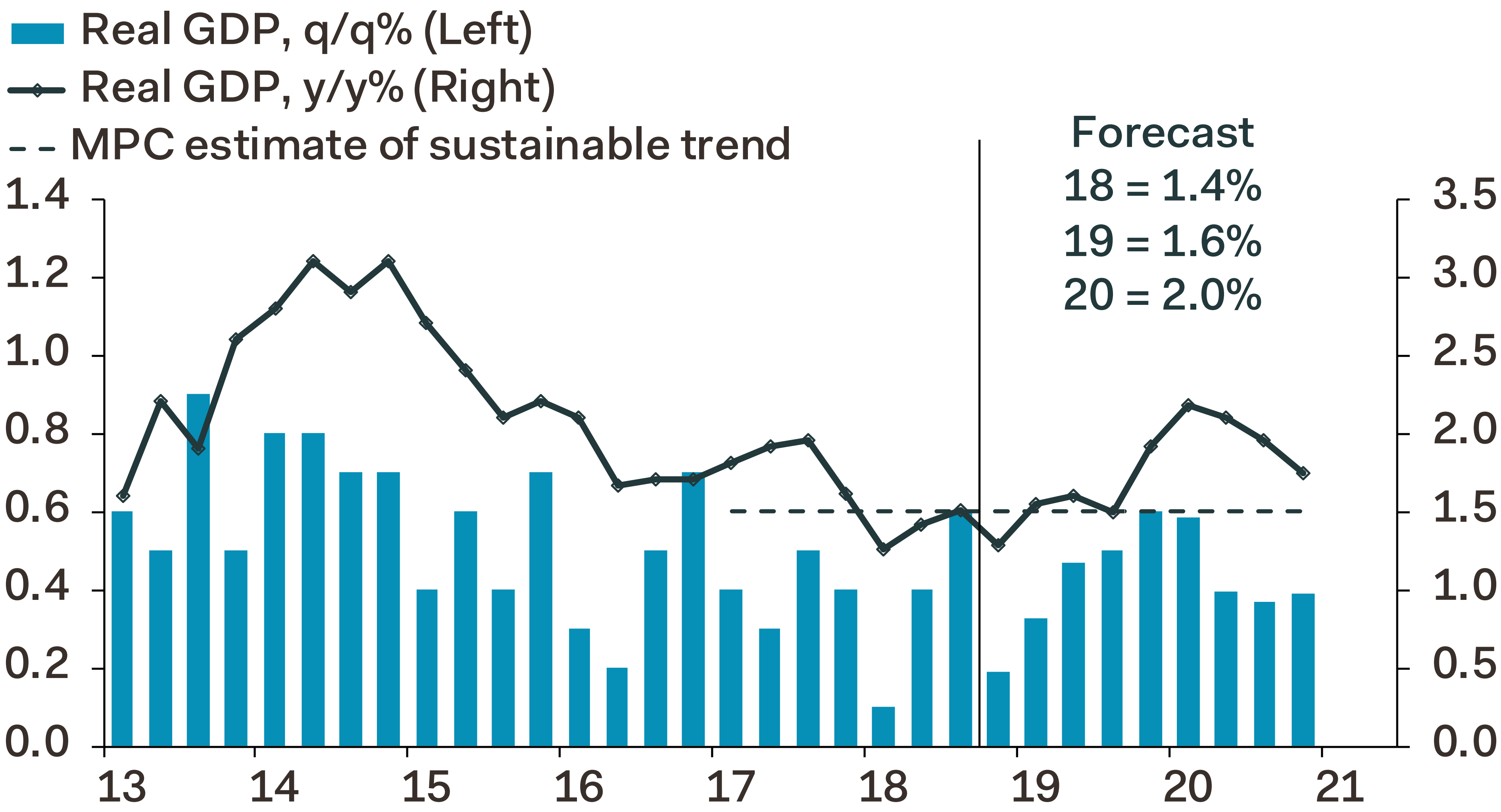
20. BREXIT UNCERTAINTY INCREASINGLY HAS WEIGHED ON INVESTMENT



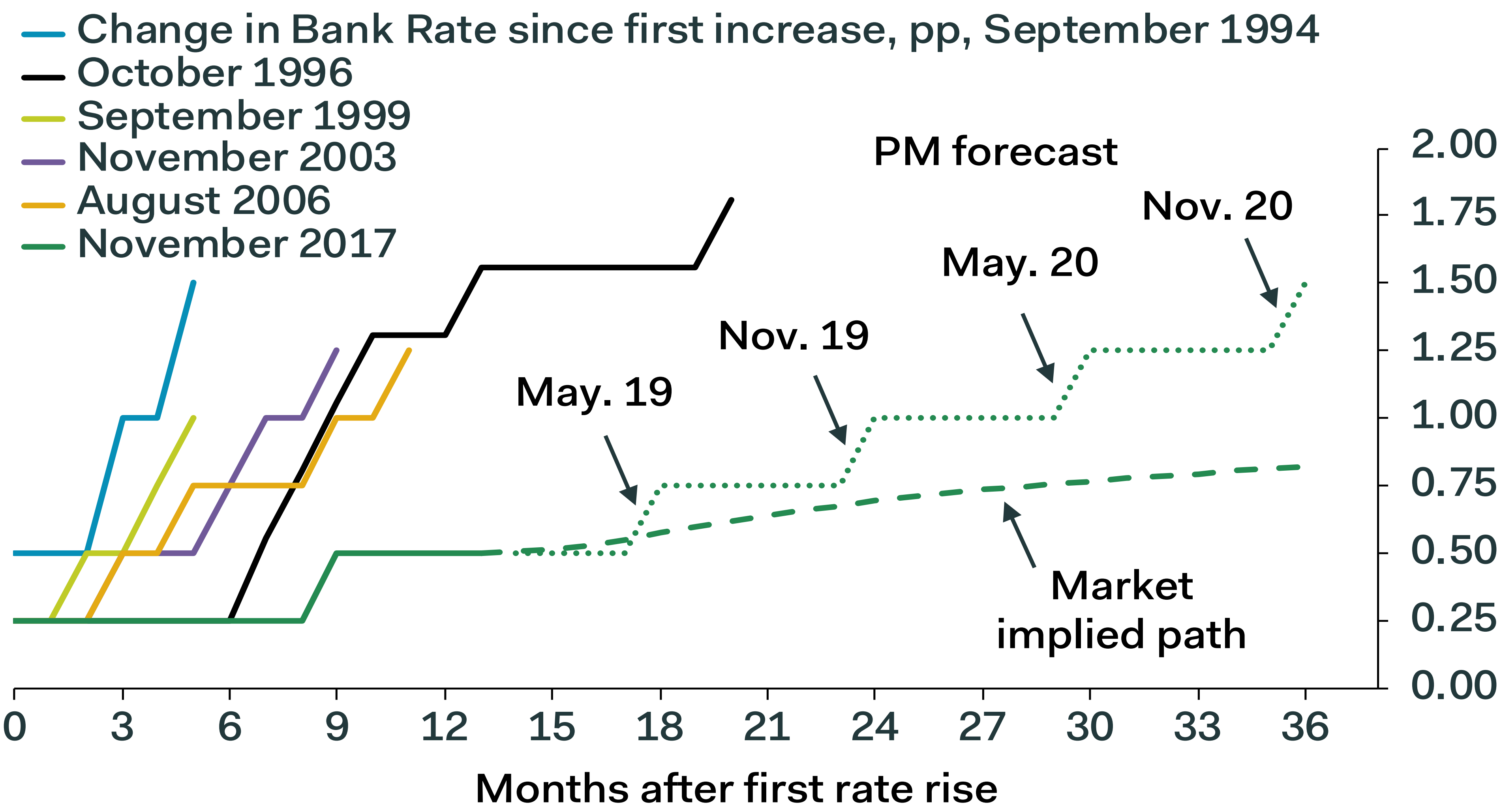
21. EXCESS CORPORATE CASH SHOULD BE SPENT AFTER A SOFT BREXIT



22. GDP GROWTH LIKELY WILL SPEED UP IN THE SECOND HALF OF THIS YEAR



23. ONE RATE HIKE EVERY SIX MONTHS STILL WOULD BE "GRADUAL"



24. EXPECT THE PACE OF TIGHTENING TO INCREASE, AFTER A SOFT BREXIT

* The MPC signalled clearly a need for further rate hikes in November.

* While GDP growth has slowed more than it expected, fiscal stimulus has been enacted and wage growth has picked up.

* Below-target current inflation hasn't prevented the MPC raising Bank Rate before and won't this time either.

* The MPC needn't hold back due to the downturn in equity prices.

* An EEA-style soft Brexit is the only sort that could command a majority in the current Commons. Don't rule out a second referendum either.

* The resulting release of pent-up investment should push GDP growth above its trend, encouraging the MPC to raise Bank Rate by 25bp every six months.