Global Asset Management

BlueBay Asset Management

The Old Lady Wakes Up

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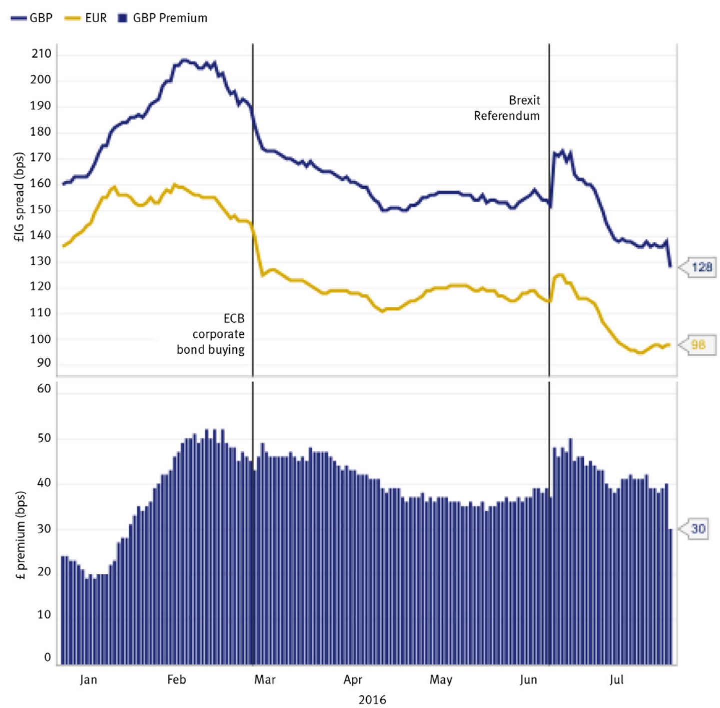
After a period of slumber, the Old Lady of Threadneedle Street – the satirical caricature of the Bank of England (BoE)– woke up with a comprehensive package of monetary and credit easing measures to counter the anticipated post-Brexit downturn in the British economy. The Bank of England does not believe it has run out of ammunition and stated that it is likely to cut interest rates further, though not into negative territory, and expand its other stimulus measures.

In a surprise to some market participants, the BoE announced that from mid-September it will start buying up to £10bn of sterling investment grade (IG) corporate bonds issued by companies making a 'material contribution' to the UK economy (i.e. paying taxes and employing people in the UK). The BoE said that £150bn of bonds will likely to be eligible under its Corporate Bond Purchase Scheme (CBPS) out of a market of some £400bn. We think that the BoE will be able to buy at least £300-400m per month (compared to the ECB monthly run rate of €7bn ≈ £6.2bn). If, as we believe, the CBPS kick-starts the moribund primary market (just £6bn of issuance so far this year) the BoE will be able to increase the pace and potentially scale of its asset purchases.

Following Thursday's (4 August) CBPS announcement, sterling credit is currently 'bid only' and spreads tightened 10-15 basis points (bps). It would not be unexpected for a similar size tightening over the coming weeks that would reduce the 'GBP premium' over euro-denominated IG corporate credit to its pre-Brexit referendum level (see Exhibit 1). With euro and now sterling corporate bond yields and spreads compressing on the back of central bank buying, the global search for yield that is boosting the emerging market debt and U.S. credit markets will if anything intensify.

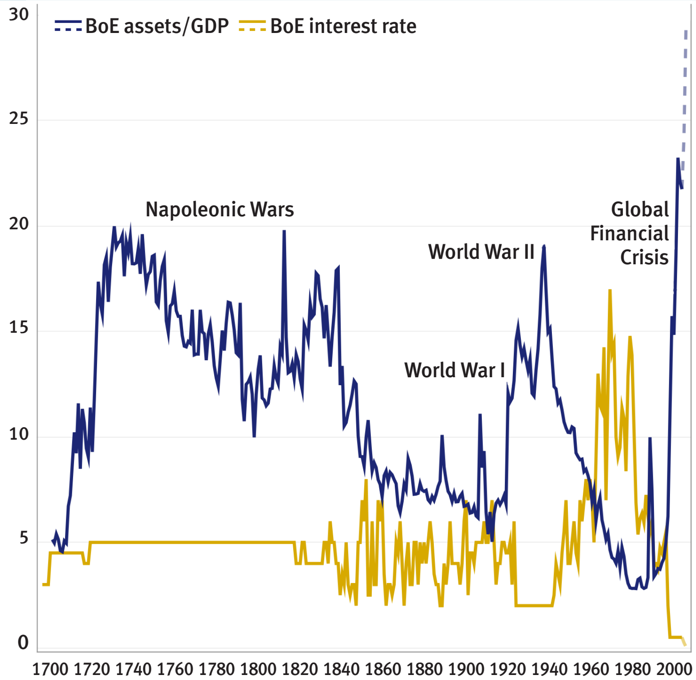
According to the BoE, its corporate bond purchases could provide a bigger boost to the economy, pound for pound, than purchases of gilts (government bonds) and without the adverse side-effects of ultra-low interest rates and government bond quantitative easing on banks. A new Term Funding Scheme (TFS) aims to reinforce the pass-through of the cut in the BoE's base rate to households and companies by offering 4-year funding at the base rate to UK banks that maintain or expand their loan book (similar to the ECB's targeted long-term refinancing operation, TLTRO) by partially offsetting the negative impact on banks' net interest margins. The BoE says as much as £100bn could be drawn down by UK banks under the TFS. The BoE also decided to exclude deposits with it from the calculation of banks' leverage ratio in addition to the previously announced elimination of the countercyclical capital buffer. The BoE is not the only central bank and regulator that is seeking to mitigate the negative impact of the low growth and interest rate environment on banks, a shift that we believe is supportive of bank capital instruments.

Exhibit 1
Sterling and Euro Non-financial IG Corporate Credit Spreads



Source: BoAML Euro and GBP nonfinancial coporate bond indices [EN00 & URNF] OAS; BlueBay calculations; data at 04/08/2016, 04/08/2016, 04/08/2016

Exhibit 2
History and Future of Bank of England Balance Sheet and Interest Rates



Source: Bank of England: BlueBay calculations; data at 2017, 2017
Note: assumes £100bn increase in BoE assets under its Terms Funding Scheme (TIFS) and £70bn in outright asset purchases

The Old Lady's headline policy actions were to cut the policy rate (the base rate) to 0.25%, the lowest level since the BoE's inception in 1694, and buy a further £60bn of gilts. BoE Governor Mark Carney indicated that further policy easing is likely and the market is pricing a further 20bps cut that would leave the base rate at just 0.05%. However, Governor Carney also made clear that the BoE will not adopt a negative policy interest rate. The extraordinary nature of the current era of economic and financial domination by central banks is illustrated in Exhibit 2 which shows BoE policy rate and balance sheet size relative to GDP (including our projections based on policy announcements and current market pricing).

Investors hoping that Japan would lead the way towards combined and large-scale fiscal and monetary stimulus were disappointed by the latest Bank of Japan and government policy announcements. It may be that the UK – committed to fiscal austerity and expected to follow the U.S. Federal Reserve in 'normalising' interest rates less than two months ago – will become the poster-child for coordinated monetary and fiscal easing and a less 'bank-hostile' environment. It is not only domestic investors keenly awaiting the UK Chancellor of the Exchequer fiscal plans in the November 'Autumn Statement'.