Liquid Insight

Bank of England preview: 25bp and risks of more hikes

10 May 2023

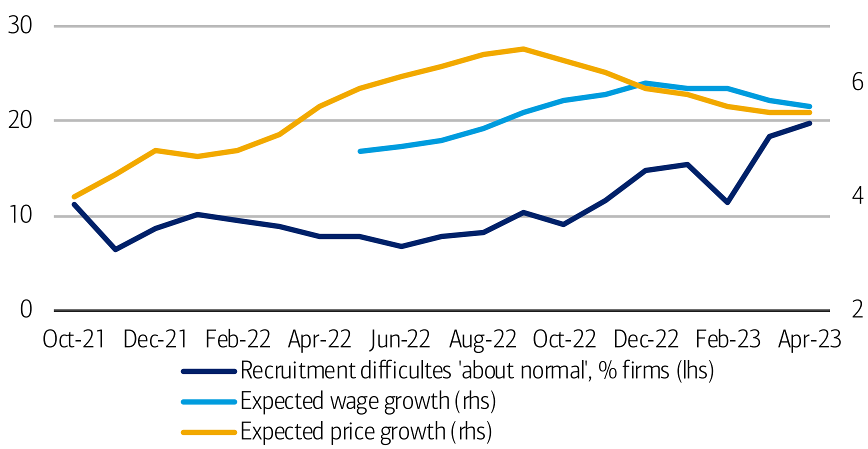
Rates and Currencies Research
Global

Key takeaways

- We expect the BoE to raise Bank Rate 25bp this week. 7-2 vote in favour with Tenreyro and Dhingra calling for no change.
- We expect BoE to pause after this hike. But risks skew to another hike in June. Guidance likely remains biased to hike.
- Rates: History implies lower yields & bull steepening with BoE on hold, idiosyncrasies complicate. GBP: communication focus.

By Robert Wood, Mark Capleton, Agne Stengeryte & Michalis Rousakis

Chart of the day: Recruitmenmt difficulties, expected wage growth and inflation, Bank of England Decision Maker Panel
Labour market gradually easing, but not fast enough for Bank of England



Source: Bank of England

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We expect the Bank of England (BoE) to raise the Bank Rate 25bp this week, with a 7-2 vote in favour. We see Silvana Tenreyro and Swati Dhingra dissenting in favour of no change in rates. We expect no substantial changes to guidance, with the BoE biased towards hiking further if it sees signs of more persistence.

We forecast no further rate hikes after this week, with terminal therefore at 4.5%. Risks skew to more hikes, however. The labour market is easing and the BoE seems cautious about hiking further given the refinancing pressure for mortgagors. But the labour market remains very tight and underlying inflation pressures sticky. In our view, the UK has one of the most severe persistent inflation problems among developed market economies so we expect fewer rate cuts than the market in 2024.

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25bp hike as inflation and wages surprise to upside

> "The MPC would continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wage growth and services inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required." (Minutes of March Bank of England policy meeting)

Consistent with their guidance from the last policy meeting, we expect the BoE to raise the Bank Rate 25bp this week. Inflation and wage growth were stronger than the BoE expected, so we think they are likely to conclude there is evidence of more persistent inflation. We expect a 7-2 vote for a 25bp hike, with Dhingra and Tenreyro dissenting, preferring no change.

News more nuanced than headlines

Inflation surprised the BoE 90bp on the upside in March. But services inflation, the component the BoE focuses on in its guidance, was a little weaker than they expected (Exhibit 1). The BoE will, we think, likely conclude that only part of the goods inflation strength, which has driven the overall inflation surprise, is 'persistent'. This leaves the inflation news a little nuanced. As does the likely drop in headline inflation well below the BoE's previous forecasts from April due to lower energy prices.

Exhibit 1: Inflation, BoEf vs. data and BofAf

Services inflation weaker than BoE expected, goods much stronger

	Headline		Core services			Core goods	
	BoEf	BofAf	BoEf	BoEf ex-VAT adj	BofAf	BoEf	BofAf
Dec-22	10.5	10.5	6.5	6.7	6.7	5.8	5.8
Jan-23	10.1	10.1	6.7	6.8	6.2	5.2	5.6
Feb-23	9.9	10.4	6.9	7.1	6.9	4.7	5.7
Mar-23	9.2	10.1	6.8	7.1	6.9	4.2	5.7
Apr-23	8.7	7.7	7.1	7.1	6.8	4.1	5.3
May-23	8.6	7.4	7.1	7.1	6.7	4.3	5.5
Jun-23	8.1	6.6	7	7.0	6.4	4.4	5.1

Source: BofA Global Research, ONS, BoE.

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The BoE had forecast annual private sector regular pay growth to flatten out at just over 7% in the Spring. Private regular pay growth rose to 7.0% yoy in March from 6.9%. 3- and 6- month annualised pay growth sit at 6% and 6.7% respectively. This will have been an upside surprise to the BoE we think but pay growth still seems likely to peak around 7.25%. Surveys continue to suggest recruitment difficulties and wage pressure easing gradually, although perhaps not as fast as the BoE hoped (Chart of the Day).

Still undershooting 2% in medium term

We expect the BoE to raise 2023 and 2024 growth despite a higher interest rate conditioning path. Business surveys suggest growth has begun to recover. That forecast change means less spare capacity will open over the forecast period, raising wage growth and inflation forecasts (Exhibit 2).

But we expect the BoE to continue forecasting inflation to undershoot the 2% target in the medium term. Their previous forecasts were well below the target. Lower utility prices will cut inflation from 2Q 2023 for a year and in the final year of the BoE's forecast, in our view. The government's fuel duty freeze will also cut inflation and sterling's appreciation should knock around 10bp off the forecast in the medium term. We see potential for the BoE to bring some of the 80bp upside skew to its inflation forecasts into the central case (mode), concluding that the data show some of the upside risks they previously identified coming to pass. That may reduce the upward revision to the mean inflation forecast, giving the forecasts a dovish feel.

Overall, we expect the BoE to forecast a faster inflation drop this year but then inflation stabilising at a higher rate than before because of less spare capacity. We still expect the BoE to forecast inflation undershooting its target in the medium term as restrictive monetary policy and fiscal policy open up spare capacity.

Exhibit 2: BofAf for BoEf
Growth and inflation up, still undershooting target

	GDP % yoy	Inflation	Unemployment	AWE
2023 2Q	0.1 (-0.7)	7.6 (8.5)	3.9 (4.1)	5.5 (4)
2024 2Q	0.1 (-0.3)	2.3 (1.8)	4.3 (4.7)	4 (2.25)
2025 2Q	0.4 (0.2)	1.7 (1.6)	4.7 (5.4)	2.5 (2)
2026 2Q	0.9	1.6	5.3	

Source: BofA Global Research, BoE

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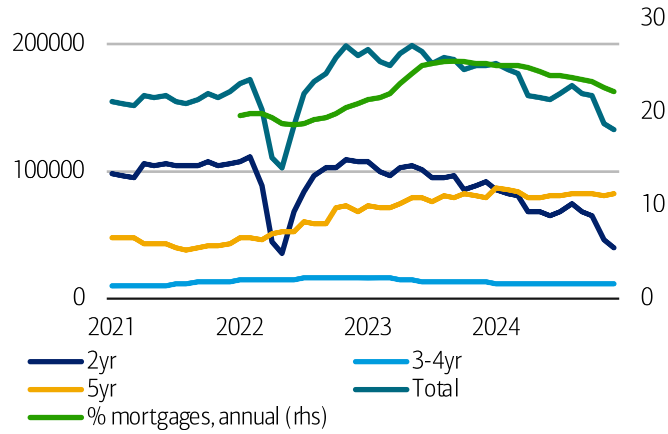
Exhibit 3: BofAf mortgage refinancing volume
Relatively few mortgagors have refinanced so far



Source: BofA Global Research, UK Finance, Bank of England.

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Some of demand improvement from easing supply shocks

The UK economy has been driven by four supply shocks: energy; supply chain disruptions; Brexit; workforce sickness. As BoE Chief Economist Huw Pill noted, as those shocks have eased, the BoE should expect stronger growth and a faster inflation fall. The key judgement in this set of forecasts will be how much of the stronger growth they have seen is due to easing supply shocks and how much is due to genuinely stronger demand. The former may not require a monetary policy response, the latter does. Different rate setters will likely come to different judgements. This leaves considerable uncertainty about where the BoE's forecasts end up, as rate setters have given few hints so far of quantitatively how they view the data (aside from noting the data has been net hawkish).

BoE to stay cautious

The BoE's forecasts rest on two key judgements. First, that strong wage growth is due to high spot inflation, so the BoE forecasts wage growth to slow as headline inflation drops. Second, much of the effect of its policy tightening to date is yet to come through. Most of the impact of monetary policy comes via household cash flow in the UK. But that cash flow effect is likely considerably delayed relative to the past (Exhibit 3).

Risks of further hikes, but a pause soon

We expect the BoE to pause after this week's hike, leaving terminal at 4.5%. We see risks skewed to another hike in June or August. We think the BoE will pause hikes soon because it will in our view be more inclined to hold rates in restrictive territory for longer than to target an ever-higher peak given their concerns about how much of the effect of monetary policy is still to come through. They will remain data dependent, however. More upside news in wages and/or inflation would lead to more hikes.

Rates: Roadmap to BoE on hold

For Exhibits related to the below analysis, please see the Rates – UK section of Global Rates Weekly published on 5 May 2023.

Heading into this week's Monetary Policy Committee (MPC) meeting, the market is pricing the BoE to hike 70bp cumulatively by September 2023. The market is also pricing a subsequent 25bp cut by March 2024. As the BoE's last hike nears, a historical check on the Bank shifting to an on-hold stance implies similar conclusions to the US (see report: Rates roadmap for a Fed on hold, 20 April 2023). One important difference is that timing the last hike matters in the UK. In both cases, bearing in mind idiosyncrasies of the current cycle against the past ones is important.

Duration: 2y and 5y Gilts performed well following the last BoE rate hike in 1998, 2000, 2004 and 2007, rallying some 100bp on average in the first six months after. Rally in 10y appeared to be more short-lived, amounting 75bp on average. Timing the last hike was important: investors were typically slightly penalised for being 2-3 months early, with the rally 2-3m after exceeding the prior selloff by 15-25bp on average. Assuming May MPC to be the last hike would imply that the current market forwards price in less than 10bp rally in 10y Sonia and even less in Gilts 6m ahead. High possibility of further hike(s) beyond May and the relative importance of timing the last hike might help explain market's reluctance to price in significantly more than that.

Curve: On the curve, the current 2s10s has been trading increasingly in bull-steepening/bear-flattening dynamic. Market forwards also appear to be pricing around 20-25bp of bull steepening in the six months ahead in Sonia and Gilts. From a historical perspective, 2s10s Gilt curve tending to bull steepen at the end of the hiking cycle is explained by the approaching rate cuts to contain a slowdown. In the cycles analysed, on average the first cut occurred eight months after last hike. The curve should then bear steepen if the Bank keeps rates credibly on hold while the longer end of the curve starts to price in the early expansion phase.

The idiosyncratic nature of the current cycle complicates historical comparison. We expect the BoE to pause hikes after May as headline inflation begins falling sharply from the April data. But the BoE will continue to be biased to further hikes while data dependent. Another hike in June is a close call at this point and we think the BoE will need a protracted period of very weak growth to bring inflation sustainably to 2% with inflation expectations having modestly deanchored up. If the BoE pauses soon, it will need to hold rates at that level for a protracted period. We see fewer cuts than the market.

Overall, comparison of current market pricing to historical precedent suggests duration to be clearer expression to play approaching last hike than the curve. But uncertainty about the number of hikes ahead coupled with importance of timing makes it tricky still.

GBP – BoE communication in focus

With markets pricing rate hikes that extend beyond the upcoming BoE meeting, the GBP focus will likely be on the BoE communication – whether the BoE agrees with market pricing, or how strongly it pushes against it.

While the worst is probably over for GBP, we remain cautious in the coming months, leaning against market pricing for the BoE and seeing challenges by risk sentiment (see also European Rates Viewpoint: Charting UK Rates and FX – May 2023 08 May 2023).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- Market concerns and FX implications, **Global FX Weekly**, 5 May 2023
- Deposits, Data and Debt**, Global Rates Weekly**, 5 May 2023
- Ahead of a busy week, **Liquid Cross Border Flows**, 2 May 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Market concerns and FX implications 05 May 2023

Global Rates Weekly: Deposits, Data and Debt 05 May 2023

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