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Liquid Insight

Bank of England preview: one more hike and done

20 September 2023

Rates and Currencies Research
Global

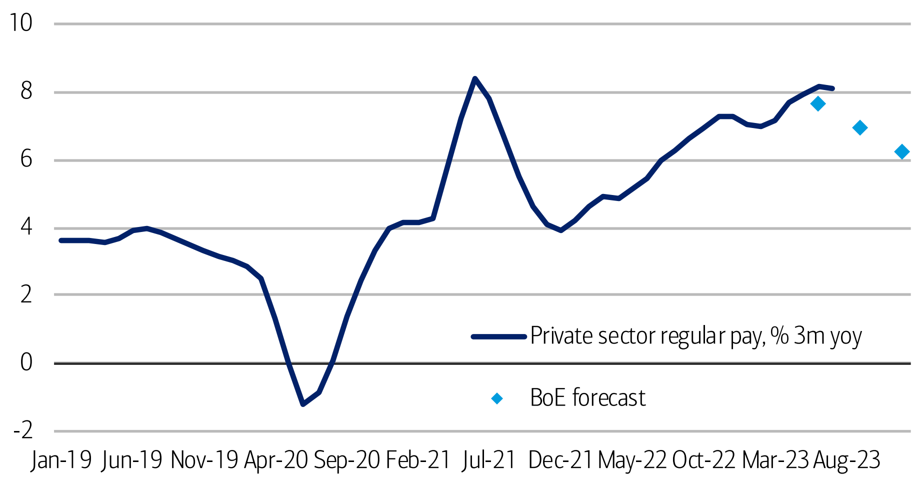
Key takeaways

- We expect the BoE to hike Bank Rate 25bp on Thursday to 5.5% terminal. We expect no rate cuts before 2025.
- Conflicting data make this month's BoE decision a closer call, but strong wage growth will tip the BoE to a hike in our view.
- GBP - BoE unlikely to be of more help near term; Gilts - strong case for tilting Gilt sales shorter, given fall in APF WAM.

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

Chart of the day: Pay growth again exceeds Bank of England forecast

Private sector regular pay growth and Bank of England forecast



Source: BofA Global Research, ONS, Bank of England

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Private sector ex-bonus pay growth has accelerated since the BoE's last meeting, exceeding their forecast, and sits at 8.1% yoy. That wage strength leads us to expect the BoE to hike 25bp on Thursday, to 5.5% terminal. We expect the BoE to pause hikes after this week, as wage growth and inflation slow. We expect no cuts before end-2024.

We look for an 8-1 vote in favour of a 25bp hike, with Dhingra preferring no change. We also expect the BoE to announce £100bn Quantitative Tightening (QT) over the next year. Conflicting data signals make this month's BoE decision a closer call, in our view. Inflation data on Wednesday morning will be key. Guidance may be tweaked to recognise that policy is closer to sufficiently restrictive, but we expect the bias to remain to further rate hikes.

Global Rates & Currencies Research
MLI (UK)

Robert Wood
UK Economist
MLI (UK)
+44 20 7996 7415
robert.d.wood@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Agne Stengeryte
Rates Strategist
MLI (UK)
+44 75 41694477
agne.stengeryte@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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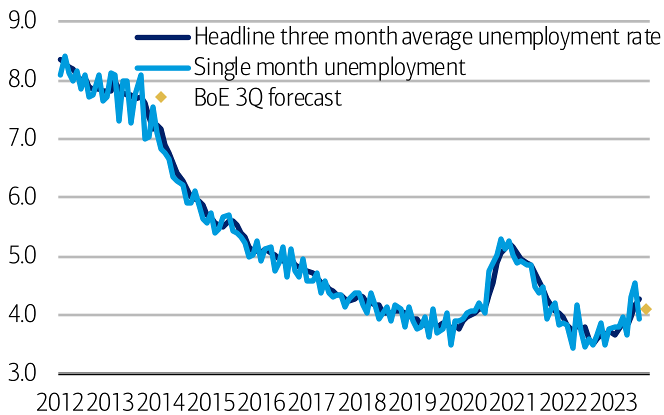
Indicators conflict

The Bank of England's (BoE) guidance said it would focus on tightness of the labour market, wage growth and services inflation when judging whether to hike further. The BoE said any signs of greater inflation persistance in those indicators would warrant a further hike.

This month, those three indicators give conflicting conclusions. Unemployment has risen more than the BoE expected up to July but wage growth has exceeded BoE forecasts (Exhibit 1 and Exhibit 2). Services inflation was 10bp above the BoE's forecast for July. August data due on Wednesday morning could be important to the BoE's decision. We expect services inflation to fall in-line with the BoE's forecast but risks skew up.

Exhibit 1: Labour mrket loosening more than BoE forecast
Unemployment rate and BoE forecast



Source: BofA Global Research, ONS, BoE

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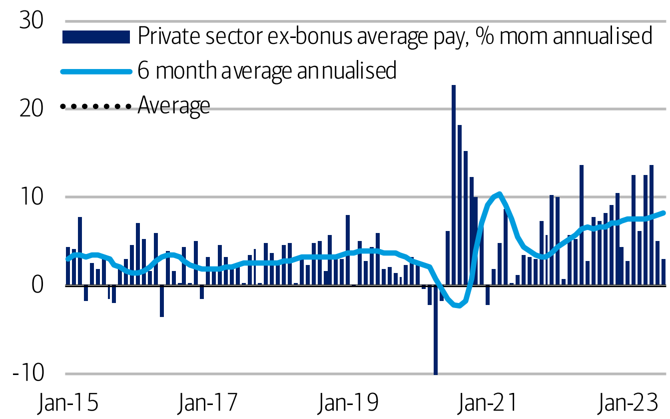
Exhibit 2: Pay growth remains very strong
Private sector regular pay growth, annualised



Source: BofA Global Research, ONS

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Closer call

Assuming inflation is in-line with our call, one of the BoE's three key indicators would be dovish, one in-line and one hawkish. This month's interest rate decision is a more balanced one than in previous months.

The BoE also highlighted resilience of the economy in its guidance. Regardless of the guidance, the BoE bases decisions on more than just the three data points above. Several recent datapoints combine to give a sense that growth is weaker than expected, which might suggest policy is more restrictive than previously thought. GDP fell more than expected in July (UK Watch: Softer economy than thought 13 September 2023), employment fell more than expected (UK Watch: An easing UK labour market gives options 12 September 2023, and the housing market appears to be weaker. There are reasons for caution about interpreting one month's data. But these data suggest some additional caution from the BoE, in our view.

One more hike

We think the core of the Committee could build a case for a skip to see more data or a hike to deal with extra persistence. We think the latter argument will likely prevail.

Leading indicators like slack are not yet reliable guides to future wage growth, given the wage surprises most recently. Private sector regular pay growth is above 8%, far above a rate that would be consistent with hitting the inflation target anytime soon. The upside wage growth surprise has been larger than the surprise in labour market slack, suggesting the former dominates. So we see one more hike and then a pause. But as we say above, the inflation data Wednesday morning will be important.

8-1 vote and £100bn QT

We expect an 8-1 vote in favour of a 25bp hike, with Dhingra supporting no change and the other eight members preferring a 25bp hike. We see balanced risks to this call. As well as a decision on interest rates, the BoE will next week determine the amount of Quantitative Tightening (QT) to be undertaken over the 12 months from October. We expect the BoE to announce £100bn gilt QT over the year from October, up from £80bn in the past year. That would comprise similar active sales to the past year of £50.5bn (£44.7bn in the past 12 months) and higher redemptions of £49.6bn compared to £35.3bn in the past year.

No change to guidance, but risks softened slightly

We expect the BoE to keep the core of its guidance unchanged, saying that signs of more persistence would require more rate hikes. It is too early to declare victory in our view, with unemployment low, private wage growth above 8% and core inflation a little below 7%. We think the BoE would prefer to keep marginal further hikes priced, rather than shift guidance dovish and encourage much earlier cuts to be priced.

We think the risks skew to a slight dovish shift to guidance, however. Governor Bailey recently suggested that in his view, the BoE was 'coming to the end of the cycle' for rates. This seemed to us more a statement of what the BoE had already said in the August Monetary Policy Report than a new view, but his latest words were more explicit. The BoE could shift focus more towards leading than lagging indicators. For instance, "If inflation and wage growth continue to slow, including pay settlements, it would be appropriate to place relatively more weight on indicators of slack." By referencing pay settlements, the BoE would be suggesting it would not know if policy was sufficiently restrictive until the next wage round is completed in the new year. We think the BoE could alternatively add a sentence to the end of its guidance suggesting that the Committee would review whether policy was sufficiently restrictive at the November Monetary Policy Report, when they would have new forecasts and a supply side review.

Reduced risks of more

We think of two conditions for the BoE pausing hikes. First, wage growth needs to be moving in-line with their forecasts. Second, core inflation, particularly services inflation, needs to show a convincing downward trend. We do not see that this month, but we think both conditions will be more likely to be met by November.

Several BoE speakers have argued a preference for a 'table mountain' path of rates, 'higher for longer' in other words, over a sharper peak and then cuts. Catherine Mann argues the opposite but appears to be an outlier. This would suggest a willingness to pause relatively early as the inflation outlook improves – to pause while wage growth and core inflation remain high, as long as they are falling – rather than taking a higher risk of overtightening.

Cannot conclude job is done

The big picture for the UK, as we described in detail here (see UK Viewpoint: Entrenched inflation = high for long 01 September 2023), is in our view an economy hit by multiple supply shocks: Brexit, supply chain disruptions, energy prices, workforce sickness. As some of those fade (supply chains, energy prices – recent oil price rises are nowhere near the same magnitude shock as the rise in gas prices last year), inflation pressure should ease and growth improve. The question is how much those shocks and the intervening period of high inflation dislodged expectations and shifted structural factors like the NAIRU (inflation neutral unemployment rate), and so how much inflation is now 'entrenched'. Additionally, Brexit and workforce sickness will in our view likely impose a more persistent drag on potential output and potential output growth, restricting how fast the UK can grow without setting off inflation.

In our view, inflation expectations have deanchored up somewhat and the NAIRU has probably risen. This means the UK has a more severe persistent inflation problem than other developed market economies, in our view, and will have to keep policy rates higher for longer than elsewhere. We see no cuts before 2025. For the BoE, we think they will not relax at least until they see hard data on pay settlements early next year.

Rates: could the BoE tweak its QT "buckets"?

We take it as almost a done deal that the amount of Gilt QT will be increased to £100bn for the year from October, especially after a strong steer from Cunliffe and the message conveyed by Governor Bailey that QT is operating in the background smoothly, with minimal market impact.

However, we think the case for tilting sales shorter is strong, for a number of reasons.

The Bank has been selling Gilts with equal amounts in the same 3-7y, 7-20y and 20y+ buckets that it used to buy them. That might sound sensible, except that the passage of time and the Gilt market sell-off means that the weighted average maturity (WAM) of the QE portfolio has collapsed.

Although the Bank measures changes to the stock of QE in original purchase cost terms, sales are conducted in equal *market value* amounts in each bucket. This means it is doing far more QT at the long end, because it is selling those Gilts at less than half their cost.

This means that the Bank is selling a disproportionately large share of longs. For a telling comparison, consider the following. It makes sense not to sell 0-1y Gilts (because that would reduce the passive roll-off, increasing uncertainty about the required active sales amount over the twelve month run). Nevertheless, the market value of 1-3y Gilts held, at £119bn (over a mere two-year span), now exceeds the total value of Over 20y Gilts held (£108bn)!

We consider the case for selling these 1-3y Gilts to be quite strong – their scarcity is reflected in their richness on repo and versus swaps, and by selling fewer longs the Bank would not be front-loading the crystallisation of losses so aggressively.

We expect the Debt Management Office (DMO) to lift the rate of the Standing Repo Facility by 25bp, in line with our Bank rate call, maintaining the “corridor” at 75bp.

Rates: DMO's SRF – time for a change in "corridor"?

The Debt Management Office (DMO) raised its Standing Repo Facility (SRF) rate to 4.50% in August, keeping the SRF to Bank rate spread (the "corridor") at 75bp. As in the month prior, the DMO stated in August that it was reserving its right to keep this policy under review and to revise the 75bp spread or other terms at any time, including in the light of prevailing interest rates, market conditions and/or market practices.

In our view, there are a few arguments to make both in favour and against widening the "corridor" – the use of SRF has gone down in H1 2023; liquidity has improved since Q4 2022; but short-dated Gilt supply is unlikely to alleviate front-end scarcity further soon; and there should be *less* need for punitive spread now than earlier (see Little Dipper, 15 September). To us, the balance of arguments points to an unchanged SRF corridor.

GBP: BoE unlikely to be of more help near term

With the BoE likely done this week and the market (especially Hedge Funds) already long GBP, we think it will be hard for GBP to rally near term.

We see downside GBP risks mainly vs. USD and some of the commodity G10 FX on growth reasons (and hopes of China stimulus in the case of the latter), but we expect GBP to trade largely sideways vs. EUR, given carry and the also weak Eurozone data.

We would *not* view any BoE hikes after this week (not our call) as positive for GBP on growth reasons, but markets have tended to see this differently. Either way, our relative central bank outlook for this year and next vs. markets points to downside risks to our 1.24 cable year-end forecast but leave us more comfortable with our 0.85 EURGBP one.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The art of pausing **Global FX Weekly**, 15 Sep 2023
- Little Dipper **Global Rates Weekly**, 15 Sep 2023
- Ahead of the ECB & US CPI, **Liquid Cross Border Flows**, 11 Sep 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: The art of pausing 15 September 2023

Global Rates Weekly: Little Dipper 15 September 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com

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