Liquid Insight

Bank of England preview: Final hike

21 March 2023

Rates and Currencies Research
Global

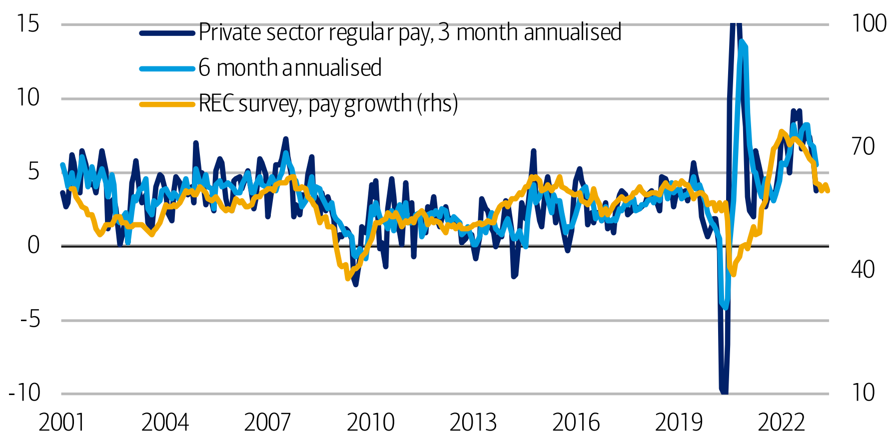
Key takeaways

- We expect a 25bp Bank of England rate hike this week, with dovish guidance. But it's a very close call.
- We would not be surprised to see the BoE keep rates on hold. Either way, we expect no further hikes after this week.
- Rates: Staying humble going into MPC. FX: Position unwind remains a dominant driver for £. Looking for selling opportunities.

By Robert Wood, Mark Capleton, Kamal Sharma & Agne Stengeryte

Chart of the day: UK annualized private sector pay growth and REC survey

Private pay growth slows sharply, but stabilizing around 4%



Source: BofA Global Research, ONS, S&P Global, Recruitment and Employment Confederation (REC).

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Before recent events, we expected a final 25bp Bank of England (BoE) rate hike for 4.25% terminal but thought that it was a closer call than market pricing. The BoE in February shifted away from a presumption that the next move would be a hike, guiding that upside data surprises woud be needed to raise rates further. The data since then has been mixed, as noted by Governor Bailey and Chief Economist Huw Pill. Wage growth slowed (Chart of the Day), but GDP growth was stronger than expected. Banking sector events add reasons for caution. That makes this week's decision a very close call. We would not be surprised if the BoE holds rates. But for now, we stick with our call for a 25bp hike. A downside surprise in inflation data on Wednesday morning could tip the balance. Either way, we expect a further dovish shift to guidance and no further hikes after this week.

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Moved away from presumption of more hikes

> "The MPC would continue to monitor closely indications of persistent inflationary pressures, including the tightness of labor market condition and the behavior 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 Bank of England Monetary Policy Committee Meeting, 2/2/23)

The Bank of England moved away from the presumption that the next move in rates would be a hike with the above guidance in February. They signaled that they would need hawkish data surprises relative to their forecast in order to warrant more hikes.

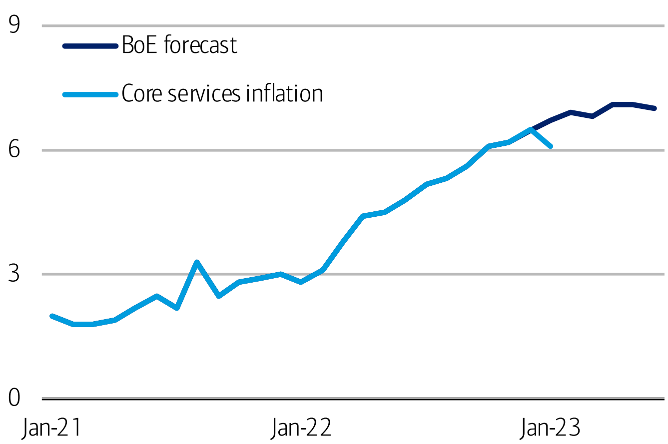
Since then Governor Bailey and Chief Economist Pill suggested that the market interpreted the guidance change correctly. They have described the data as mixed, suggesting no firm directionality. Pill also seemed to suggest in his mid-February speech that it may be sensible to hold in March and return to consider the question of hikes in May:

> "Both the March and May MPC meetings represent points at which the Committee can again assess the implications of incoming data for the monetary policy stance, with the latter having the advantage of an updated comprehensive assessment in the form of the MPC forecasts. " ('Inflation is a 'wicked problem" – speech by Huw Pill, 16 February 2023)

The main dovish news at the time of Pill and Bailey's speeches was core services inflation (Exhibit 1). On the hawkish side was PMIs indicating that the UK will avoid a recession – a material upside to BoE forecasts for 2Q if PMIs remained at that level. The mixed data has continued since Pill and Bailey spoke, with GDP growth in January being stronger than the BoE expected but wage growth weaker (see Chart of the Day), and inflation expectations dropping on all horizons. We discuss the data in detail in [UK Viewpoint: Better, not good, downside risks 17 March 2023](#).

Exhibit 1: Core services CPI inflation

Core services inflation 60bp weaker than BoE forecast in January



Core services inflation excludes airfares, package holidays and education. **Source:** BofA Global Research

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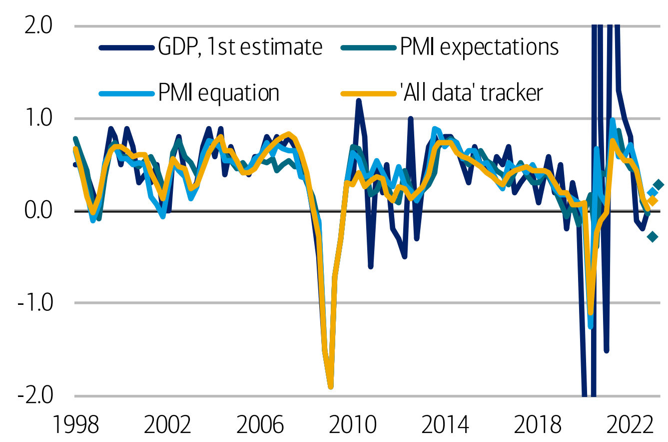
Exhibit 2: GDP growth qoq and survey-based trackers

Surveys suggest UK will avoid recession



Source: BofA Global Research, S&P Global, ONS.

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Meeting: A close call before banking sector problems

With the BoE being more dovish than other major central banks, we argued, before recent banking sector problems, that the March rate decision was a closer call than the foregone conclusion the market was pricing (see UK Watch: Inflation forecast update: on the way down 02 March 2023).

Although it was a close call we had still expected the BoE to hike by 25bp in March, to a 4.25% terminal, despite the mixed data because we assumed the BoE would instead focus on the big picture. The UK economy has been driven by 4 large supply shocks: energy; supply-chain disruptions; Brexit; workforce sickness. The first two of these have been easing, opening up an easier path back to target. Easing supply shocks is consistent with the stronger growth and weaker inflation we see in the data. The question was whether the BoE would think 4% Bank Rate would be enough to ensure a prompt return to the inflation target. On balance, we thought GDP growth was perhaps a little too strong and signs of the labor market stabilizing a little too early, to allow the BoE to stop. So our call, on balance, was one more hike and done.

The question now is whether banking sector problems are enough to tip the BoE into holding rates. In the near-term, we would expect the BoE to assert the same separation principle as the ECB (see UK Viewpoint: Better, not good, downside risks 17 March 2023). The difference between the ECB and BoE, however, is that the BoE was already much closer to pausing. And greater uncertainty over the economic outlook as well as potentially tighter credit conditions could therefore tip the BoE into holding rates.

The counter argument to holding now is that pausing may potentially signal to the market more concern about the banking sector. Some rate setters may also be concerned about the exchange rate reaction if the BoE holds and the Fed hikes, though we doubt the exchange rate will be key for many rate setters. Or alternatively, it may be too early for the BoE to have a strong view on the evolution of credit conditions, yet it may see a need to address inflation. In our view, the dovish interpretation likely dominates, especially considering that Chief Economist Pill already seemed to suggest pausing in March.

So it's a very close call, in our view, probably 50-50 at this point. We would not be surprised at all to see the BoE keep rates on hold. CPI inflation on Wednesday morning, UK time, could tip the balance. We expect core services inflation to print even further below the BoE forecasts compared to January. But inflation can be volatile, so the potential for a surprise is high. If headline inflation surprises on the downside (vs. the BoE's 9.9%), as well as core and core services, a hold this week may become the most likely outcome.

Hard to predict vote

Given that we think the rate decision is a close call, precisely how the vote splits is particularly hard to have conviction over. In our base case of a 25bp hike, we would expect perhaps a 6-3 vote, meaning one more voter shifts to preferring rates on hold than in the previous meeting. If the BoE kept rates on hold it could be a close to unanimous decision, perhaps an 8-1 or 7-2, with mixed data and banking issues dominating. There may be an outside risk of one rate setter voting for a cut or signaling that they would be minded to do so soon.

Beyond this month

We had previously described the UK as having the greatest inflation persistence problem (see Global Economic Weekly: Inflating worries 17 February 2023). As a result, we do not expect a rapid turn to rate cuts, forecasting two cuts next year, even though we think March will signal the end of the hiking cycle. That view is of course predicated on credit conditions not tightening sufficiently or fast enough to drive much weaker growth than we expect (we still forecast a mild recession). We, like the BoE, will need to watch the evolution of the banking sector problems carefully.

Rates: Staying humble

At the front-end, we are heading into this week's Monetary Policy Committee (MPC) meeting empty handed. On 17 February, we entered a receive March MPC-dated Sonia trade at 4.15%, targeting 3.90% with a stop of 4.30%. We saw the trade as a cheap way to position for the BoE pausing/stopping hiking in March (see UK: Plenty of rides at the front-end park, 17 February). At the time, the market was pricing near-certainty that the BoE would hike by 25bp at the meeting.

This week's rally in rates globally resulted in March MPC Sonia now pricing in only 14bp. What happens this week will likely depend on: (1) whether BoE expects contagion from the US and/or whether uncertainty about that should lead them to want to wait, and (2) the data flow. On the latter, the inflation release later this week will be critical. In any case, the option to position for no hike in March is no longer as cheap, and we closed the trade last week (see 'Closing receive March MPC dated Sonia shy of target', 13 March).

FX: The one constant – rates do not matter for £

Our recent analysis has shown that GBP has been agnostic to UK rate moves in recent years. We do not think this is about to change any time soon (see: FX Viewpoint: GBP: And so it begins 15 March 2023). For now, position cleansing, a standard market response to a crisis will continue to dominate sentiment. EUR/GBP has been a favored long this year and our momentum indicators have been flashing overbought levels. Much will depend on the evolution of the current period of volatility, but we cannot see a situation where deteriorating global liquidity conditions will not undermine global cross-border flows essential to the financing of the UK's current account deficit. For now, markets are more concerned about fault lines rather than the central bank mandate to tame inflation. This means that data is unlikely to be a factor in the near-term. Already, there are signs that GBP has overshot some of its anchors. We think the opportunity to sell into this rally is approaching.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022

- Central bank policy dilemmas begin, but focus on inflation prevails for now, **Global FX Weekly**, 17 Mar 2023

- Rate stress test **Global Rates Weekly**, 17 Mar 2023

- USD roller coaster, **Liquid Cross Border Flows**, 13 Mar 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: Central bank policy dilemmas begin, but focus on inflation prevails for now 17 March 2023

Global Rates Weekly: Rate stress test 17 March 2023

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