UK Watch

Bank of England Review: options open

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Increased risks of another hike

The minutes of the Bank of England's (BoE) policy today raise upside risks to our terminal rate call of 4.25%. They left enough optionality to hike again but we stick to our call of no more hikes. Our forecast will be sensitive to the data flow, especially the next inflation reading and any impact on credit conditions from recent banking sector turmoil.

7-2 vote for 25bp

The BoE hiked rates 25bp as expected with the same 7-2 vote split as in February. The minutes were mostly balanced, noting faster than expected drops in wage growth offset by stronger than expected demand. The large upside inflation miss on Wednesday was a key reason to hike. Though the BoE argued that inflation miss did not signal much greater persistence as it was driven by stronger food and clothes inflation than forecast, which can be volatile (or for food was driven by shortages) and so may not persist. The BoE expects inflation to fall even faster this year than they previously thought, because of government policies (energy price and duty freezes).

Lower energy prices boost medium term inflation

Whether the BoE was hawkish or dovish comes down to how one balances the BoE's views on prospective demand growth, with strength from past data and lower energy prices against risks from tighter credit conditions. On balance we read the minutes as putting more weight on the former and therefore modestly hawkish.

The BoE argues lower energy prices, lower precautionary saving and further fiscal stimulus would on net boost demand and inflation i.e. the demand effect on inflation would dominate in the medium term over reduced second round effects from lower headline near-term. There is a hint of inconsistency here: the BoE argued second round effects from higher energy prices would dominate the impact of weaker demand, and now lower second round effects from weaker headline would be dominated by stronger demand. Though there is a little more going on, with fiscal help.

This hawkish argument is balanced by the BoE noting "The MPC would continue to monitor closely any effects [of banking issues] on the credit conditions faced by households and businesses"; "Uncertainties around the financial and economic outlook had risen".

The BoE's key guidance sentence, that signs of *more* persistence would be needed to justify further hikes, remains unchanged and the BoE notes "The MPC would make a full assessment of all of the news since the February Report, including the economic implications of recent financial market and banking sector developments, as part of its forthcoming May forecast round." **(Continued on next page.)**

Options open

The BoE left its options fully open in our view. The BoE now expects stronger medium-term inflation pressure subject to banking sector issues. But the BoE was previously forecasting inflation below target in the medium term with Bank Rate peaking lower than priced now. So that medium-term strength may justify their previous hikes more than it justifies more from here. The upside inflation surprise, much as the BoE downplays it, seems to have been key to their decision, as expected. That makes the next inflation print important and especially how much of the surprise in clothes, food and catering prices proves lasting. The BoE's guidance seems to suggest they need signs of *more* persistence relative to their view updated today in order to hike further though.

On balance, we think the BoE leans a little more hawkish today, given the focus on demand news, and so the risks of another hike have risen. But for now we stick with our call and await potential further clarity from any BoE speakers and the data.

We continue to think the UK faces a persistent inflation problem and therefore that they will, after reaching terminal either already or soon, be slow to cut.

Rates: Are we there yet?

We read BoE's MPC minutes as raising upside risks to our terminal rate call of 4.25% on balance. Our Chief UK Economist Rob Wood sticks to no more hikes for now, but the BoE has left enough optionality to hike if needed. Our forecast – as well as market pricing - will be highly sensitive to the data flow, especially the next inflation reading and any repercussions on credit conditions from recent banking sector turmoil.

Unlike yesterday's market interpretation of the Fed's 25bp hike as a clearly dovish one - expressed by a sharp 14bp bull steepening of the 2s10s USTs curve – the UK's market reaction was more mixed. 2s10s Gilt curve bull steepened a few basis points above midday levels, but only after flattening in the immediate aftermath first. At the time of writing 2y Gilts are trading some 5bp lower than at midday, while 10y is down 2bp.

The MPC-dated Sonia is now pricing a nearly 65% chance of another 25bp hike in May. Terminal Bank rate is priced at nearly 4.6%. We see this as broadly fair pricing given our base case and risks to it. We would be tempted to receive May MPC dated Sonia if pricing of 25bp Bank rate hike in May moved closer to certainty (unless it moved for reasons that would lead us to change our base case scenario also).

Further out, BoE stopping the hikes should be consistent with steeper Sonia curve, as implied in our forecasts, but another hike in May would delay that dynamic towards the middle of 2023. We continue to expect 2y Gilts to underperform relative to 2y Sonia and 2s20s Gilt ASW curve to steepen, on the back of significant skew shorter in Gilt issuance by the DMO from April. In inflation, we retain our upside bias in UK breakevens, with the current iteration of the view expressed at the very long end of the curve.

GBP: Second-order impacts matter more

GBP is broadly unchanged following the rate decision after an initial push higher on the announcement. A key theme in our sterling view has been its declining sensitivity to the UK rate cycle and this has once again been in evidence at the March meeting. The BoE has followed the path set by other central banks in recent days by hiking rates and enforcing the separation principle between financial stability and its inflation mandate. As with other central banks, credit/financial conditions are likely to become an increasingly important part of the reaction function and the extent to which tightening standards equates into de facto policy tightening. In buying some time the MPC have given themselves some optionality to hike further should the need arise. The phrase persistent inflation will be a useful anchor to argue the case for more policy tightening whilst slowing inflationary pressures and wages growth allows them to go on hold. For GBP, much of this may not matter as much as the broader risk backdrop and particularly as expectations around the UK have normalised to some extent. Higher rates may reflect increased confidence in the macro-backdrop but this only matter if it is accompanied by renewed interest in foreign participation in UK Plc.

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