UK Viewpoint

Bank of England preview: persistence vs more hikes

26 July 2023

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25bp hike

We expect the Bank of England (BoE) to hike Bank Rate by 25bp at next week's policy meeting. We look for a three-way split vote, 1-7-1, with Dhingra preferring no change in rates and Mann a 50bp hike. We see risks skewed to a more hawkish vote.

Inflation surprised less this time

We expect the BoE to slow down to a 25bp hike because data has surprised less to the upside in the run up to the August meeting than it did before the June meeting. This is not a judgement free assessment. The key data have not all surprised in the same direction and we cannot measure the precise surprise to the BoE as they did not publish updated forecasts in June. So we cannot rule out that the BoE judges the data requires another 50bp rate hike, although we think that is less likely than it was in June.

Forecast story = persistence vs hikes

We expect the BoE to raise end-2023 wage growth to 6.5% and end-2024 to 4.5%. In our view the BoE will judge that the extra rate hikes priced by the market and sterling's appreciation will be more than sufficient to offset extra inflation pressure from wages. We see the BoE's two-year ahead mean inflation forecast unchanged at 1.8% and the three-year ahead forecast cut from 2.0% to 1.6%. The forecasts would be implicitly endorsing further hikes, but not as many as priced– a familiar story for BoE forecasts.

Guidance unchanged

We expect unchanged guidance, continuing to provide no directional steer on rates. This will clash with forecasts that suggest further hikes would be needed to hit the inflation target, but that was the case in May and June as well. We see a risk that the BoE shifts focus more to the average level of rates over the forecast, rather than the precise path.

Rates: time to rethink BoE cuts that might follow

Steepening of 1y forward 1s3s Sonia after last Wednesday's inflation number suggested to us that the market's interpretation was more about the level of peak rates and the path to it, but not so much about cuts that might follow. A shift in the Committee's focus towards the average setting of policy could draw the market's attention to the latter. Market taking out/postponing rate cuts could be the next catalyst for front-end steepening. High-for-longer should be supportive for paid forward real rates also.

GBP: bearish risks around the meeting

With markets pricing a non-trivial chance of a 50bp hike next week and a higher terminal than in our base case, we see downside GBP risks around the upcoming BoE meeting, also given the long GBP positioning. Further out, we remain concerned around UK hard-landing risks although recent data offer some hope. We continue to expect cable lower by year-end, but we now find risks to EURGBP more symmetric than a month ago.

Refer to important disclosures on page 10 to 12.
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Timestamp: 26 July 2023 07:34AM EDT

25bp hike

We expect the Bank of England (BoE) to hike Bank Rate by 25bp at next week's policy meeting. We look for a three-way split vote, 1-7-1, with Swati Dhingra preferring no change in rates and Catherine Mann preferring a 50bp hike. We see risks skewed to a more hawkish vote.

Scale of inflation surprise drove 50bp hike in June

The Committee argued the scale of data surprise in June was important in determining the size of hike.

> "The scale of the recent upside surprises in official estimates of wage growth and services CPI inflation suggested a 0.5 percentage point increase in interest rates was required at this particular meeting." (June 2023 minutes of Monetary Policy Committee meeting.)

The BoE also seemed concerned that the persistence of inflation shocks may be exacerbated by the resilience of demand, a potential non-linear effect.

> "There has been significant upside news in recent data that indicates more persistence in the inflation process, against the background of a tight labour market and continued resilience in demand." (June 2023 minutes of Monetary Policy Committee meeting.)

This adds demand to the other three indicators –labour market slack, wage growth and services inflation – the BoE said it was monitoring closely:

> "The MPC will continue to monitor closely indications of persistent inflationary pressures in the economy as a whole, including the tightness of labour market conditions and the behaviour of wage growth and services price inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required." (Minutes of June 2023 Monetary Policy Committee meeting)

Note in that guidance the BoE does not define the benchmark against which persistence is judged. "More than" what? This matters particularly this month as the BoE reacted forcefully in June to upside data surprises. Are they now comparing data outturns to new implicit forecasts for wages and inflation, or still to the May forecasts. We assume the former primarily.

As well as demand resilience, the Committee seemed to reduce the weight it placed on survey indicators as they had not given a good steer recently, raising the importance of the hard data on wages and inflation. The recent slowing in goods inflation may give the BoE some more confidence in the signal from producer price inflation.

> "Some indicators of future pay growth and goods inflation had weakened, but their properties as leading indicators had not been tested in a similar period of high inflation." (June 2023 minutes of Monetary Policy Committee meeting.)

Wages and inflation have surprised less this time

We expect the BoE to slow down to a 25bp hike because data has on balance surprised less to the upside in the run up to the August meeting than it did before the June meeting (Exhibit 1). This is not a judgement free assessment. The data have not all surprised in the same direction and judging the precise surprise is complicated by the BoE adjusting its expectations at the June meeting without publishing precise numbers. So we cannot rule out that the BoE judges the data requires another 50bp rate hike.

Exhibit 1 compares the data to the BoE's forecasts from the May Monetary Policy Report. Before the June monetary policy meeting all the indicators in the BoE's guidance surprised hawkishly. Since June the news has been mixed. Labour market tightness has surprised dovishly while wages and inflation surprised hawkishly again.

Services inflation, however, surprised less in the latest data than prior to the June rate decision. Moreover, the minutes of the June rate setting meeting said "Services CPI inflation is projected to remain broadly unchanged in the near term." This suggests to us that the BoE had raised its forecast for services inflation in response to the stronger than expected data in June. So we should compare the latest services inflation to an expectation of 7.4%. In that case services inflation surprised the BoE on the downside.

Wage growth surprised the BoE's May forecasts more on the upside this month than before the June meeting. The BoE did not signal how it may have changed its implicit wage growth forecast at the June meeting, but we think it's unlikely the BoE would have expected wage growth of 6.8% in the lastest data after a 7.6% growth rate in June.

Another way of framing this discussion is whether the BoE's 50bp hike in June was in there view sufficient to account for data news to that point, and further hikes should be assessed from that jumping off point. Or if they think more in 'accelerationist' terms, that 50bp was the required response to 7.6% or wage growth. We argue below for the former, hence our assessment of the data here.

Indicators of GDP growth have slowed. The PMI for instance fell to 50.7 in July suggesting downside risks to the BoE's forecast of underlying GDP growth around ¼% qoq. It would be unusual for the BoE to hike with a PMI close to 50, and especially, hike 50bp, though of course the PMI is not one of the top three indicators the BoE is currently tracking whereas it was in previous cycles.

At the least we can argue the key data over the past month have been more mixed relative to BoE expectations than before the June meeting. We had argued before the June meeting that there was a reasonable probability of a 50bp hike, although we expected 25bp given the BoE's previous caution (see [UK Watch: Bank of England preview: lots to do 15 June 2023](). Less hawkish data surprises now to us suggest a 25bp hike is the most likely outcome this time, and more likely than in June.

Exhibit 1: Less hawkish data surprises this month

Latest available data at time of BoE rate setting meeting

	May	June	Aug	BoEf (May MPR)		Surprise for BoE	
Labour market tightness				June	August	June	August
Unemployment	3.8%	3.8%	4.0%	3.8%	3.8%	0.0%	0.2%
Employment, % qoq	0.5%	0.9%	0.3%	0.5%[1]	0.5%[1]	0.4%	-0.2%
Wage growth							
Private sector regular pay, %3m yoy	7.0%	7.6%	7.7%	7.1%[2]	6.8%[2]	0.5%	0.9%
Whole economy pay, %3m yoy	5.8%	6.7%	6.9%				
Services inflation	6.9%	7.4%	7.2%	6.8%	6.7%	0.6%	0.5%
Composite PMI	54.9	52.8	50.7				

[1] End-203 forecast as monthly BoE forecasts not available. [2] Monthy BoE forecast for June rate setting meeting, BofAe of monthly forecast for August, calculated by interpolating BoE quarterly forecasts. **Source:** BofA Global Research, ONS, BoE.

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Forecast story = more persistence…

The new economic forecasts are a way to combine observations like that from Dave Ramsden, below, and wage growth continuing to increase with our view that the BoE slows to a 25bp hike.

> "CPI inflation has begun to fall significantly but remains much too high." (Dave Ramsden, Speech to Money Macro and Finance Society, 19/7/23)
>
> "…indicators of persistence in prices are "above where they were" in May." (Comments on 19/7/23 reported by Bloomberg)

We expect the BoE to raise its wage growth forecasts by 150bp for 3Q 2023 and 100bp for 3Q 2024 (Exhibit 2). We have argued that is because consumers and firms seem to be responding more to headline inflation than lower inflation expectations (UK Watch: Wage growth higher for longer 14 July 2023). Such a forecast change would reflect Ramsden's observation that indicators of persistence have risen since May.

Exhibit 2: We expect the BoE to raise its wage forecasts, reflecting more persistence
BofA forecast for Aug MPR (May MPR), mean forecast for inflation, mode for everything else

	GDP % yoy	Inflation	Unemployment	AWE
2023 3Q	0.7 (0.6)	7.0 (7.0)	4.0 (3.8)	6.5 (5)
2024 3Q	0.4 (0.6)	3.7 (3.7)	4.1 (3.9)	4.5 (3.5)
2025 3Q	0.5 (0.8)	1.8 (1.8)	4.6 (4.4)	3 (2.5)
2026 3Q	0.7	1.6	4.9	2.5

Source: BofA Global Research, BoE.

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… Vs. more hikes

Stronger wage growth would, all else equal, raise the BoE's medium term inflation forecasts. But higher expected interest rates than in May will cut inflation forecasts.

So far we have data for 12 of the 15 working days over which the BoE averages market prices to condition its forecast on. On that basis trade weighted sterling is 4.3% above the level used in the May forecasts, peak Bank Rate is 126bp higher at just over 6%, and average Bank Rate over the BoE's three-year forecast period has risen 132bp. Utility price inflation is also, in our view, likely to be lower over the next year than the BoE expected in May.

We expect higher interest rates and sterling to offset higher wage growth, leaving the BoE's inflation forecasts to be unchanged at the one and two-year forecast horizons and lower at the third year (Exhibit 3). Why lower at three years? We expect the BoE's changes to its wage growth forecast to be less persistent than the market's repricing of Bank Rate. By end-2025 the market prices 100bp higher Bank Rate than in May we think the BoE will raise its end-2025 wage growth forecast one-third of the amount it raises end-2023. Hence the rise in Bank Rate expectations deliver increasingly below target inflation later in the forecast.

This forecast then allows combining Ramsden's observations, which reflect the data in Exhibit 1, with a 25bp rate hike. Greater inflation pressures and persistence than in the May forecast are countered by higher interest rates, in part already delivered in the form of the 50bp rate hike in June. We expect the BoE to validate much of the increase in market rate expectations but not all, consistent with a terminal rate at around 5.5-5.75%.

Exhibit 3: Higher rates bring inflation back to target again at two years, but push it below at three
BofA forecast of contributions to change in **mean** inflation forecast relative to May.

	2023 3Q	2024 3Q	2025 3Q	2026 3Q
May MPR	7.0	3.7	1.8	2.0
+ Persistence	0.2	0.6	0.5	0.1
+ Utilities	-0.1	-0.3	0	0
+ Bank Rate	0.0	-0.1	-0.2	-0.3
+ Exchange rate	0.0	-0.2	-0.3	-0.1
= BofAf Aug MPR	7.0	3.7	1.8	1.6

Source: BofA Global Research, BoE

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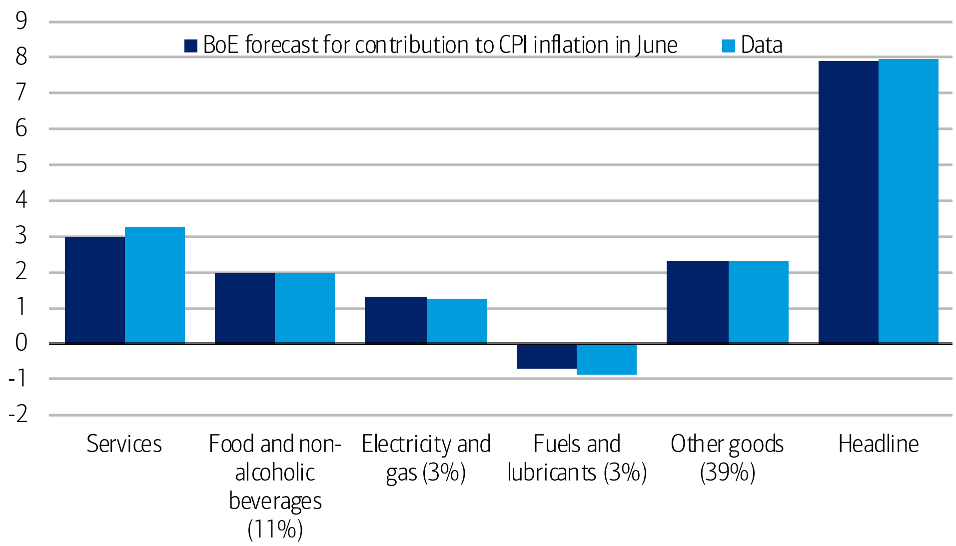
Risks of higher two-three-year inflation forecast

We think the risks skew to a higher two-three-year inflation forecast than we expect. Wage growth is not the only data point showing greater persistence. While headline inflation has fallen back in line with the BoE's May forecasts, that reflects weaker than expected petrol inflation offset by stronger than expected services inflation (Exhibit 1).

This could have various implications. The BoE may interpret higher services inflation as a sign of greater persistence and therefore add more to the two-three-year ahead inflation forecast than we assume in Exhibit 3. But some of that higher-than-expected inflation could reflect continued passthrough of energy costs to non-energy components, which could unwind by 2-3 years ahead. Moreover, to the extent that firms are changing prices *quicker* in response to cost changes, higher inflation today may imply a faster fall tomorrow. On balance we think the mix of inflation news poses upside risks to our call in Exhibit 3.

Exhibit 4: Inflation in-line with BoE forecast, but persistent components stronger, petrol weaker
CPI inflation vs. BoE's May forecasts



Source: BofA Global Research, ONS, BoE

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No change in strategy in June

In our view the BoE's 50bp hike in June did not signal a change in its reaction function. An alternative view would be that the larger than expected hike in June signals a change in BoE strategy to front loading rate hikes more – suggesting that data in-line with the June meeting would lead to another 50bp hike. That could suggest a higher probability of a 50bp hike in August than we argued above.

But we think the BoE is shifting away from focusing on the terminal rate and more towards the length of time it may need to hold rates at a restrictive level. For instance, the minutes of the June MPC meeting shifted to focusing on the average level of Bank Rate over the forecast period rather than the path:

> "At the time of the previous MPC meeting and May Monetary Policy Report, the market-implied path for Bank Rate averaged just over 4% over the next three years. Since then, gilt yields have risen materially, particularly at shorter maturities, now suggesting a path for Bank Rate that averages around 5½%. Mortgage rates have also risen notably. The sterling effective exchange rate has appreciated further." (Minutes of June 2023 Monetary Policy Committee meeting)

The BoE kept its guidance unchanged in June, suggesting a neutral stance on the direction of the next move in rates:

> "The MPC will continue to monitor closely indications of persistent inflationary pressures in the economy as a whole, including the tightness of labour market conditions and the behaviour of wage growth and services price inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required." (Minutes of June 2023 Monetary Policy Committee meeting)

When describing that guidance language in the press conference after the May policy decision Governor Bailey said it provided no directional steer.

> "… we've repeated the language, this time, that we used in the committee in March, that we will be guided by the evidence… we are not giving what I would call a directional steer on rates today, as we didn't last time. We will be guided by the evidence… if we see further signs of greater persistence, then, of course, we'll have to act." (Andrew Bailey, May 2023 Monetary Policy Report Press Conference)

More likely than a change in strategy in our view is that the BoE were in June, as the quote from the minutes at the beginning of this note shows, reacting to the scale of the data surprise. They got a large surprise so responded with a large hike. The data surprise is smaller this month than June.

Guidance to stay the same, risk of shift

As the BoE did not feel the need to change to a directional steer on rates in June – although the market interpreted their 50bp hike as giving a steer – we do not expect them to change their guidance at this meeting either. Taken literally that guidance, combined with forecasts that have inflation below target, would be dovish compared to market pricing. That said, the market seemed to ignore the guidance at the June meeting, so it's hard to argue that repeating the same words this time would lead to different market pricing.

Repeating the same guidance, that provides no directional steer on rates, would, we think, be inconsistent with forecasts that suggest further hikes are necessary. That was true in May too, although to a lesser extent with markets at the time pricing one more hike rather than the 2-3 this time.

The BoE may accept the inconsistency. Deputy Governor Ben Broadbent, for instance, said in the May press conference that the forecasts were not intended to signal anything:

> "I don't think they're [forecasts] intended to communicate something, say about future policy. Historically they were intended more to explain the current decision, because of these long lags in policy, we have to make forecasts, sometimes I wish we didn't, but we have to make forecasts. We use them to explain the current decision rather than to say, 'Here's what we're going to do for the next two or three years." (Ben Broadbent, May 2023 Monetary Policy Report Press Conference.)

We see a risk the BoE shifts its guidance further, however, given the forecasts are likely to imply a possibility of more than one further hike being required after August. One option would be to shift the burden of proof in the forecasts. They could perhaps suggest that "The Committee would continue to focus on labour market tightness, wage growth and services inflation for signs that would continue to slow. Should upside risks continue to materialise the Committee would not hesitate to raise Bank Rate further." That may run the risk of being too hawkish for the BoE's liking, especially given the caution they have previously expressed about the lagged effect of rate hikes

> "The Committee is continuing to monitor closely the impact of the significant increases in Bank Rate so far. As set out in the May Report, the greater share of fixed-rate mortgages means that the full impact of the increase in Bank Rate to date will not be felt for some time."
>
> "The Committee also recognised that it had become more important to consider developments in the rental market." (Minutes of June 2023 Monetary Policy Committee meeting)

An alternative would be to continue gradually shifting the Committee's focus towards the average setting of policy, with the implicit intention of reducing the peak in rates but extending its duration. This would be a way of marrying guidance with no directional steer with forecasts that suggest tighter policy than the market prices. Perhaps rate setters could use language similar to our expectation for the ECB this week (see Europe Economic Weekly: Extreme data-dependence 21 July 2023). So "The Committee will keep policy rates at a restrictive level for as long as necessary to sustainably return inflation to target." Or more gently, the BoE could focus more on the average policy path over the three year forecast, as in the paragraph in the June minutes quoted above, than the peak in rates.

Most likely, in our view, the BoE leaves guidance unchanged, but given the increased gap between forecasts that suggest a directional bias for policy and guidance that doesn't there is an increased risk this month of a change to guidance in our view

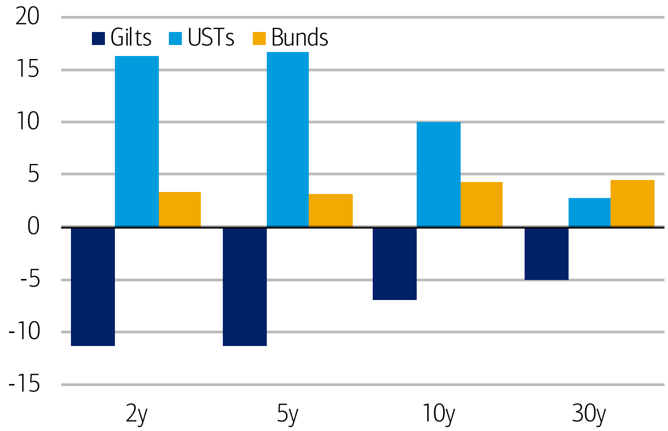
Rates: time to rethink BoE cuts that might follow

Gilt yields have rallied substantially in response to last week's June inflation downside surprise, outperforming US Treasuries and Bunds (Exhibit 5). Market pricing of terminal Bank rate has shifted lower also, to 5.85% at the time of writing. As outlined above, the near-term outlook for rate hikes remains uncertain: not all data surprises have been to the downside, so we cannot rule out another 50bp rate hike in August. But it seems less likely than it was in June. Market pricing of 37bp is reflection of these two possibilities (Exhibit 6).

Steepening of 1y forward 1s3s Sonia after last Wednesday's inflation number suggested to us that market's interpretation of the inflation release was more about the level of peak rates and the path to it, but not so much about cuts that might follow. A shift in the Committee's focus towards the average setting of policy, with the implicit intention of reducing the peak in rates but extending its duration, could draw the market's attention to the latter. The market taking out/postponing Bank rate cuts could be the next catalyst for front-end curve steepening.

Governor Bailey's remarks at Sintra about short-lived rates peak as priced in by the market seem noteworthy to us also. Our read is that we will not get the rate cuts without the confidence that inflation is well on the way to target. And it is not at all clear that rates will fall any faster or further than inflation (i.e., real policy rates could actually continue to rise for a prolonged period). A market pricing a return to negative real rates seems overly ambitious. High-for-longer should be supportive for paid forward real rates.

Exhibit 5: Yield changes since 18 July, bp
UK outperformed Europe and the US



Source: Bloomberg, BofA Global Research

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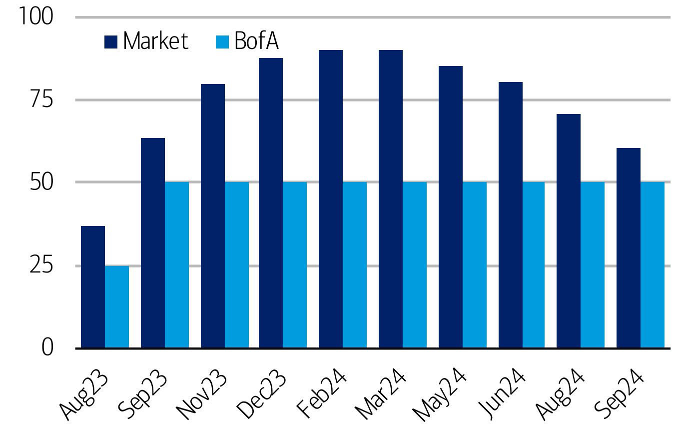
Exhibit 6: MPC-dated Sonia Bank Rate hike exp. vs. BofA f'casts, bp
Market pricing in near 100bp of hikes to peak



Source: Bloomberg, BofA Global Research

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GBP: bearish risks around the meeting

With markets pricing a non-trivial chance of a 50bp hike next week and a higher terminal than in our base case, we see downside GBP risks around the upcoming BoE meeting, also given the long GBP positioning, particularly of Hedge Funds.

Further out, we would expect currencies of central banks that succeed in bringing inflation back to target (within a reasonable time frame) to do well. Assuming the BoE's inflation-fighting resolve is not questioned (despite its often highly "Delphic" guidance), the question then is how painful UK disinflation may be. Even though UK rates are lower after the downside surprises in the US and the UK June inflation prints, they remain near levels we consider as potentially overly restrictive. In this vein, our economists have highlighted the risks around the UK public finances, particularly ahead of the UK election.

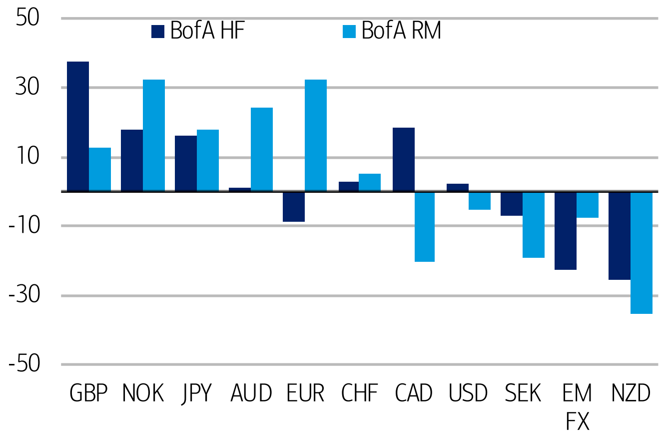
As a result, we do not view upside inflation surprises as positive for GBP (and vice versa) at the current UK rate levels. We did find the June UK CPI data encouraging, but it is still very early. We have been encouraged by *some* signs of easing in the labour market (incl. the higher labour force participation), but wage growth remains too high, and our economists do not expect meaningfully more help from labour supply near term.

Meanwhile, we remain concerned about the GBP investor positioning, which we now find to be the longest in the G10, especially for Hedge Funds (Exhibit 7). On the flip side, carry remains a GBP positive versus most G10 currencies, incl. EUR (Exhibit 8).

Bottom line: we find GBP risks slightly more balanced than a month ago (on slightly lower tail risks), but we continue to expect GBP downside vs. USD—we expect cable at 1.24 by year-end—with this mainly driven by our near-term bullish USD call.

At current levels, also given carry and the weak Eurozone data, we find risks to EURGBP to be more symmetric than a month ago, but positioning is still, on balance, an upside EURGBP risk: Real Money clients remain long EURGBP but Hedge Funds, who have likely driven the price action in the past months, remain short.

Exhibit 7: Latest BofA investor positioning
GBP longs could be at risk around the BoE meeting



Source: BofA Securities. +50 (-50) represents a max long (short) positioning relative to history. Currencies ranked on the equally-weighted average for Hedge Funds (HF) and Real Money (RM).

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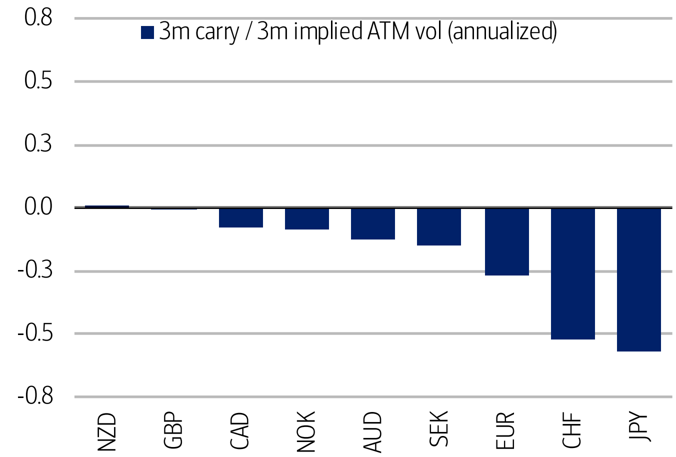
Exhibit 8: USD vs G10 FX, 3-month vol-adjusted carry (annualized)
Carry supports GBP vs most of G10 FX



Source: BofA Global research, Bloomberg

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