UK Watch

Bank of England review: none and done, probably

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Change call, expect no more BoE hikes

After the Bank of England (BoE) held rates at 5.25% today we change our call. We expect the BoE to keep rates on hold at 5.25% through 2024. Previously we expected the BoE to hold at 5.5% through 2024. We expect four 25bp rate cuts in 2025 compared to five previously. Fewer hikes now substituted for fewer cuts later.

Finely balanced decision

The BoE kept rates on hold today, compared to our and the consensus call for a 25bp hike. They upsized Quantitative Tightening to £100bn a year as expected, which we discuss in more detail below. The huge inflation surprise yesterday made today's decision an extremely close call (UK Watch: Inflation forecast update: downside surprise leaves rate decision in balance 20 September 2023). The 5-4 vote to hike 25bp and the BoE saying "the judgement to keep Bank Rate unchanged at this meeting rather than increase it was finely balanced" suggest the decision could have gone either way.

As the BoE aims off the hawkish data

Three factors tipped the balance to a hold. First the BoE argued they should not react as strongly as previously to hawkish official wage growth data because other data sources suggest a weaker picture. Second, the BoE seems prepared to look through a bounceback in services inflation in the next data print if it is driven by the volatile components that led to the downside surprise in August (Exhibit 1). The BoE argues that services inflation, which excludes the volatile items (air fares and accommodation services), had been weaker than expected. This suggests the data would have to surprise by an unusually large amount to warrant a BoE rate hike in November. Third, weaker growth data suggested previous rate hikes were feeding through more than expected.

And shifts emphasis to slack, growth and higher for longer

The minutes of today's decision suggest to us the BoE is shifting emphasis. First, away from lagging indicators of inflation pressure, like wages and inflation, and towards lead indicators like slack and growth (Exhibit 2). And second, away from further hikes to rein in inflation and towards holding rates at this level for longer (Exhibit 3). They also added a new threshold for cuts that could rule them out until the second half of next year at the earliest (if, say, material progress meant headline and core inflation below 3% and 4% sustainably, respectively, Exhibit 4).

Risk skewed to more hikes still

In short, the signal we take today about the BoE's reaction function is a strong preference, at least from the core of BoE rate setters (Bailey, Broadbent, Pill and Ramsden), to hold Bank Rate at its current level. Therefore, base case we expect no further rate hikes now. But in our view, it would be hard to rule out the risk of a further hike in November, or even in December or February next year. November will see a new set of forecasts that could be more hawkish. **(Continued on next page.)**

With lower Bank Rate, lower sterling, and probably upward revisions to the inflation neutral unemployment rate (NAIRU), the BoE will we think have to work hard to forecast inflation reaching the 2% target in the medium term in the November forecasts.

Furthermore, while the BoE can reasonably in our view argue mixed indicators now suggest a pause, in our view the BoE's bias to hold today goes against the data risks. Throughout this inflation upswing the BoE, we and consensus have been surprised by how persistent consumer price and wage inflation has been and the degree to which behaviour seems to have changed.

Step back. Private pay growth currently sits above 8% and core inflation even after a downside surprise is above 6%. Set against that are surveys suggesting weaker pay growth, a PMI in modest contractionary territory and in our view a fall in employment as odd compared to surveys as pay growth. Underlying the BoE's decision seems, in our view, to be a strong BoE view that the impact of past hike is delayed, not reduced, and that inflation expectations are strongly anchored. We think risks skew to policy effects being reduced as well as delayed and inflation expectations having deanchored somewhat. Additionally, the recent oil price rise should as a base case not dramatically affect the inflation outlook but after so many upside inflation shocks we would not have a lot of confidence in that judgement.

As we note above the BoE set a new threshold today for cuts that in our view pushes back against pricing of cuts in the first half of next year. We would add that potential risks to wage growth, for instance, mean we think it will be hard for the BoE to shift its bias away from hiking at least until it sees wage settlements signals early next year. Bottom line, we expect no further hikes but we continue to think rate cuts are a distant prospect. We assume no cuts before 2025.

Exhibit 1: Downplays accommodation inflation news, discounts future volatility
Minutes of BoE's September policy meeting

"Some of those movements are linked to services such as airfares and accommodation that tend to be volatile over the summer holiday period. Excluding these travel-related components, services inflation has been more stable at continued high rates, albeit slightly weaker than expected.

Services price inflation, however, is projected to remain elevated in the near term, with some potential month-to-month volatility."

Exhibit 2: BoE shifts emphasis towards growth and slack, away from pay and inflation
Minutes of BoE's September policy meeting

"This meant that the decision on whether to increase or to maintain Bank Rate at this meeting had become more finely balanced between the risks of not tightening policy enough when underlying inflationary pressures could still prove persistent, and not placing sufficient weight on the impact of the previous tightening that was still to come through on activity and inflation."

Exhibit 3: BoE shifts 'further tightening' sentence to end of guidance paragraph suggesting preference shifting to responding to hawkish news with higher for longer
Minutes of BoE's September policy meeting

"The MPC would continue to monitor closely indications of persistent inflationary pressures and resilience in the economy as a whole, including the tightness of labour market conditions and the behaviour of wage growth and services price inflation. Monetary policy would need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term, in line with the Committee's remit. Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures."

Exhibit 4: New threshold for cuts may not be reached until second half 2024
Minutes of BoE's September policy meeting

"Conditions were likely to warrant a restrictive policy stance being maintained until material progress had been made in returning inflation to the 2% target sustainably."

Rates – door opened for tweaks to QT "buckets"

The market seemingly interpreted BoE's hold as inflationary. With the exception of the very front-end, Gilt yields rose following the BoE announcement. Spot 1y Sonia was around 2bp down while 1y Sonia gaps 1y and 2y forward are more than 10bp up relative the previous day's close at the time of writing. Gaps further out were all trading around 10bp up relative to their prior closes. The inflation market firmed across the curve on the unchanged rates announcement, perhaps interpreting the "table mountain" approach to rates as a willingness to take more time to rein in inflation.

As expected, the Committee voted to reduce the stock of Gilts held for monetary policy purposes by £100bn over the period from October 2023 to September 2024, to a total of £658 billion. For Q4 2023, the Bank will continue to sell Gilts in even market value amounts across short, medium and long maturity "buckets". There will be four Gilt sale auctions in each of the maturity sectors, with a planned size of £670mn per auction.

The BoE did not skew Gilt sales shorter. We were not expecting it, but thought they should, and saw it as an under-priced possibility (see One more hike and done, 15 September 2023). However, we would highlight an expanded wording regarding possible future changes, which we think is significant.

Consider this paragraph from the September Asset purchase Facility (APF) Market Notice (the paragraph has been a fixture of every APF Market Notice since sales began):

Market Notice 1 September 2023

"The Bank will continue to monitor the impact of its gilt sales programme on market conditions, and reserves the right to amend its schedule, including the gilts to be sold and the size of its auctions, or any other aspect of its approach at its sole discretion."

Now consider the additional language about the even (market value) sales split:

Market Notice 21 September 2023 (addition bolded by us, not BoE)

> "The Bank will continue to monitor the impact of its gilt sales programme on market conditions, and reserves the right to amend its schedule, including the gilts to be sold and the size of its auctions, or any other aspect of its approach at its sole discretion. **As part of that, the Bank will continue to monitor whether the current approach of selling gilts evenly across short, medium and long maturity sectors in sales proceeds terms remains appropriate."**

That suggests to us that the BoE are explicitly considering the even split and could amend at any quarterly announcement. The Bank expects to announce the sales schedule for Q1 2024 at 4.30pm on 15 December 2023.

GBP: BoE unlikely to be of help near term (but may be later)

GBP weakened into today's meeting and was little changed afterwards, following a month during which GBP weakened the most in the G10 (after a very strong performance until mid-August). We are also not sure a "one and done" today would have helped GBP much and/or for more than a few minutes. Taking a step back, we think the somewhat disproportionate GBP reaction vs rates in the past days could reflect positioning—into this week, Hedge Funds remained (very) long GBP, according to our proprietary flows—which is a risk we continue to flag (see also GBP: near-term rallies harder 18 Sep 23).

Where to from here? We remain of the view the BoE won't be of much help to GBP near term, but it may be later on: a "high for longer" approach suggests risks around the BoE rate cuts priced for next year. In this sense, we feel the recent GBP weakness vs EUR is close to overdone—our economists' base case for next year includes three cuts from the ECB but none from the BoE. In the near term, we see downside GBP risks primarily vs USD, AUD, NOK, CAD, mostly on growth reasons and, in the case of commodity FX, also on China pessimism likely nearing its peak.

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