UK Watch

Bank of England Review: high for long

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Macro
United Kingdom

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

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

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

Michalis Rousakis
FX Strategist
MLI (UK)
michalis.rousakis@bofa.com

Dovish guidance change

The Bank of England (BoE) today continued the shift begun in the June minutes away from how many more hikes to 'high for long'. That guidance change was supported by the Press Conference and made today's policy decision dovish relative to market expectations. The BoE repeated the same non-directional guidance as last month that hawkish data surprises are needed for further hikes, but added two sentences. First noting that policy is restrictive, and second that the BoE would hold policy restrictive for long enough to bring inflation down to target (Exhibit 1). These additions suggest the BoE prefers a policy of holding at terminal for longer to hiking more and cutting sooner. Holding Bank Rate above 5% for longer is not 'dovish' in an absolute sense, but it suggested risks of fewer hikes than the market expected and later cuts.

Don't read much into two hawkish dissents

The BoE hiked 25bp as we and consensus expected. The 1-6-2 vote (no change, 25bp, 50bp) was more hawkish than the 1-7-1 we expected, but we would not read much into that. The two dissents were from external members of the Committee (Haskel and Mann). The core block of internals continued to vote together.

We expect one more hike, timing a little less certain

We continue to expect one more 25bp Bank Rate hike in September to 5.5% terminal. We expect the first rate cut in February 2025. Today's guidance and new forecasts from the BoE support our call. The BoE has left open the option of skipping a meeting, however. Their guidance is neutral: they need upside data surprises to hike. And Governor Bailey emphasised several times during the press conference today that interest rates constant at current levels for the next three years delivered a similar inflation forecast to following the market path. The BoE are shifting away from focusing on where terminal is and towards the policy stance needed over the next couple of years.

More hawkish forecasts than we expected

Big picture, the BoE's forecast changes were as expected. Growth cut, wage growth raised, validating some but not all of the rate hikes priced by the market. The forecasts were more hawkish than we had expected, however. The BoE raised its mean inflation forecast at the two-year horizon 20bp to 2.0%. This seems to be a result of the BoE raising its estimate of demand pressure at the start of the forecast. The mean inflation forecast at three years was 1.9%, 30bp higher than we expected, but a marginal signal that the BoE thinks the monetary stance priced by the market is a little too tight. Assuming interest rates are constant at 5.25% the mean inflation forecast is still at 2.0% at two years but is lower at 1.8% at three years. Bailey referred to this constant rate forecast in his remarks. This adds to the impression from the new guidance that the BoE would prefer to hold close to current rates for an extended period than hike more and cut more. (**Continued on next page.)**

Risks into the mode makes sense

The BoE made a technical change to its forecasts today. The BoE publishes modal and mean, or risk adjusted, inflation forecasts. Typically, we would think of monetary policy as being set from the mean. Central banks don't aim for the single most likely outcome – any single outcome has a vanishingly small probability of occurring – but rather try and balance the range of risks. In the previous two forecasts (February and May) the BoE's mean inflation forecasts were 80bp above the mode at two- and three-year horizons. This skew reflected the BoE's view that risks to its forecasts were heavily upside.

The BoE now concludes the risks are materialising and brought them into its base case, the mode. The skew falls to 30bp at two years, 40bp at three, and the modal inflation forecasts rises more relative to May than the mean. Since we think of policy as set based on the mean, not the mode, this change seems more presentational than meaningful for policy to us.

That said, by bringing the risks into the central case and cutting the skew the BoE may be signaling increased confidence in the outlook. More confidence punctuated the press conference – albeit about near-term inflation, but the sentiment seemed to our ears to seep in elsewhere. That extra confidence, and view that the risks are more balanced now than previously, also adds to the impression given from the BoE's guidance.

Hike again in September but possibility of a skip

We expect one more 25bp rate hike at the next meeting in September followed by a prolonged pause. We see the first rate cut in February 2025. We see risks to terminal skewed up because of the strength of wage growth.

The combination of the BoE's guidance change towards high for long and focus on the constant interest rate forecast, means we see the risks at the next policy meeting skewed slightly towards no change – a skip – and hiking in November instead. The BoE's near-term forecast seem more at risk of dovish news in our view. For instance, we estimate the BoE expects core inflation to rise from 6.9% to 7.0% in July compared to our call of a fall to 6.8%. A downside inflation surprise would, based on the BoE's guidance and depending also on wages, be consistent with a skip. To be clear, we see a high probability of another 25bp hike because of the strength of wage growth, notwithstanding the precise formulation of the BoE's guidance. Today's decision, for instance, suggests the BoE thinks of its guidance quite flexibly. But the BoE was at pains today to say holding rates at their current level could do the job.

Exhibit 1: BoE shifts guidance to high-for-long
BoE interest rate guidance

"*Given the significant increase in Bank Rate since the start of this tightening cycle, the current monetary policy stance was restrictive.* 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. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required. *The MPC would ensure that Bank Rate was sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term, in line with its remit.*" (Minutes of August Bank of England Monetary Policy Committee Meeting, our emphasis added to show new text to guidance added since previous month).

Rates: "higher-for-longer" steepens front-end Sonia

Heading into the August MPC we were focused on three themes: (1) a potential BoE steer towards "higher-for-longer" providing another bout of steepening to the front-end

Sonia; (2) any new information on Quantitative Tightening following Dave Ramsden's speech on 19 September; and (3) any changes to the Debt Management Office (DMO) Standing Repo Facility (SRF) rate relative to BoE's Bank rate.

Regarding the front-end Sonia curve, we argued that the inversion in the UK front-end following the BoE's June MPC meeting looked overdone. The steepening after the last set of UK inflation data suggested to us that the 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. We therefore held onto the steepening view heading into the August MPC in the hope that the Committee's focus would shift towards an average setting of policy, with the implicit intention of reducing the peak in rates but extending its duration (providing the next catalyst for front-end curve steepening). Today's MPC meeting was close to our expectation. 1y1y Sonia trading at around 5.26% implies that the next leg of front-end Sonia steepening would need to come from more Bank rate cuts being priced in by the market. We can no longer hold onto this front-end steepening view given more Bank rate cuts being priced is not our base case currently.

The two other themes did not deliver as much excitement. The MPR contained a review of the QT process, estimating that the cumulative impact to date has added 40bp to 10y yields (since the MPC vote to commence), which it said was modest as a proportion of the total increase in yields. Unlike in Dave Ramsden's speech, there was no steer on likely QT pace beyond September. We still assume a step-up to £100bn over the year to September 2024, with extra Gilt QT displacing the corporate bond QT done in the current run. The DMO raised its SRF rate to 4.50%, from 4.25% previously, keeping the corridor to the Bank rate unchanged at 75bp. The spread will remain in market focus into September MPC.

GBP – weaker into the meeting, but can benefit from a steady approach further out

The BoE meeting was on the dovish side of markets but closer to our expectations. GBP weakened into the meeting and remained largely flat afterwards. We had argued, also given Hedge Funds' long GBP position, that GBP risks were to the downside. We think this remains the case vs. USD in the near term but we now find EURGBP risks more symmetric than two months ago.

Going forward, we think a slower and steadier ("high-for-longer") BoE approach--in line with our economists' base case—would be a good outcome for GBP by reducing the tail risks of a UK harder landing. In this sense, 25bp today instead of 50bp is a positive outcome, in our view. In other words, for GBP to be supported, we think the BoE should strike a good balance between bringing inflation down to target within a reasonable timeframe and avoiding over-tightening.

The lower UK terminal rate and the softer overall Eurozone data suggest more symmetric risks for GBP vs EUR than two months ago, in our view. But we continue seeing downside risks for GBP vs USD in the near term. With Hedge Funds and Real Money being long cable but taking a different stance on EURGBP according to our analysis, positioning is in line with these risks, we think.

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