UK Watch

Bank of England Review: another hike

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One more hike and one fewer cut

In response to more hawkish than expected forecasts from the Bank of England (BoE) today we change our call. We now expect a 25bp Bank Rate hike in June to 4.75% terminal, compared to our call of no more hikes previously and 4.5% terminal. We expect one 25bp rate cut in 2024, in 3Q, compared to two previously (in 1Q and 3Q). This raises our end-2024 Bank Rate forecast to 4.5% from 4.0%.

We have low conviction on the timing and level of terminal. The BoE's guidance today could be consistent with no more hikes in our view, and / or could also be consistent with skipping the June meeting and hiking in August. The BoE left all their options open.

Big picture, however, in our view the UK has probably the biggest persistent inflation problem among developed market economies (e.g. Global Economic Weekly: Inflating worries 17 February 2023). So we had argued it was a close call whether the BoE would stop at 4.5% or hike further. We also expected fewer rate cuts than the market and thought the risks were skewed to even less. The BoE will, in our view, cut slower than other developed market central banks.

In-line decision, hawkish forecasts, unchanged guidance

BoE rate setters today voted 7-2 to hike Bank Rate 25bp to 4.5%. That was in-line with consensus and our expectations. Dhingra and Tenreyro dissented as expected, preferring to keep rates on hold. There is an open question in our view whether Tenreyro will vote for a rate cut in her final policy meeting in June given she has voted against hikes since Bank Rate reached 3.0%.

The BoE's forecasts were surprising hawkish today. They raised their 1-year, 2-year and 3-year ahead mean inflation forecasts 2.3ppt, 0.5ppt and 0.9ppt respectively. The BoE expects CPI inflation still double its 2% target in a year's time. These were larger upward revisions than we were expecting. Assuming Bank Rate follows the market path from a week ago, which peaked above 4.75%, the BoE expects inflation of 2% in 3-years time and 1.9% in 2-years time. Their mean forecasts broadly validate the market curve.

The BoE's guidance was unchanged. They continue to suggest they need upside data surprises in order to hike further, saying "If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.". That said, our proprietary BoE Mood indicator, a hawkishness score for the minutes, rose to its most hawkish since June last year. Although that is hard to interpret because the BoE shortened the minutes significantly this month creating a structural break in our Mood indicator.

(Continued on next page.)

The tension: guidance vs. forecasts

There is a tension between the BoE's forecasts seeming to validate the market curve and guidance that suggests the BoE will pause unless it sees upside surprises. This in our view makes the BoE outlook hard to read. This tension is hard to resolve because several rate setters speak infrequently, so we find it hard to judge how they individually interpret the data. And the BoE does not offer insight into its thinking on monetary strategy i.e. whether the appropriate policy is more hikes and more cuts, or fewer hikes but holding at terminal for longer.

In our view the tension is explained by the gap between the BoE's mode and mean forecasts. The BoE's view on the most likely single outcome is that inflation will undershoot the target markedly if interest rates follow the market curve. But they see large upside risks to that central case, so their mean forecast is for inflation close to target. Policy should respond to the mean – taking account of the balance of risks. But equally that means the BoE has to continually see hawkish data relative to its central case in order to conclude the upside risks are materialising and therefore justify further hikes. BoE rate setters may also have different strategies in mind.

One can easily disagree about the BoE's medium-term forecasts. Differences in opinion on persistence can drive large differences in medium term forecasts. But in the short-term the BoE's forecasts do not look to us obviously dovish. We see upside and downside risks to their inflation and wage calls for the next few months. This means we tend to see the BoE as close to pausing, given its guidance. That is why we expected 4.5% terminal before today, and continue to think a hike in June is a close call.

That said, raising inflation forecasts as much as the BoE did today would not be what we would expect from a central bank about to pause hikes. It would be an odd signal to raise inflation 50bp at the policy relevant horizon as a signal of an imminent pause.

BoE speakers may resolve some of this tension in coming weeks, but we think that is more hope than expectation. In the absence of any further information we assume one more 25bp hike in June, with low conviction. The BoE could skip June and hike in August, for instance, returning to a quarterly hiking schedule. Or it could pause here and hold at terminal for longer. Really, all options are left open. Our interpretation is consistent with a market that priced the terminal rate little changed after the Bank of England press conference, when Bailey emphasised the guidance, retracing an initial spike on the forecast change headlines (more detail in rates section below).

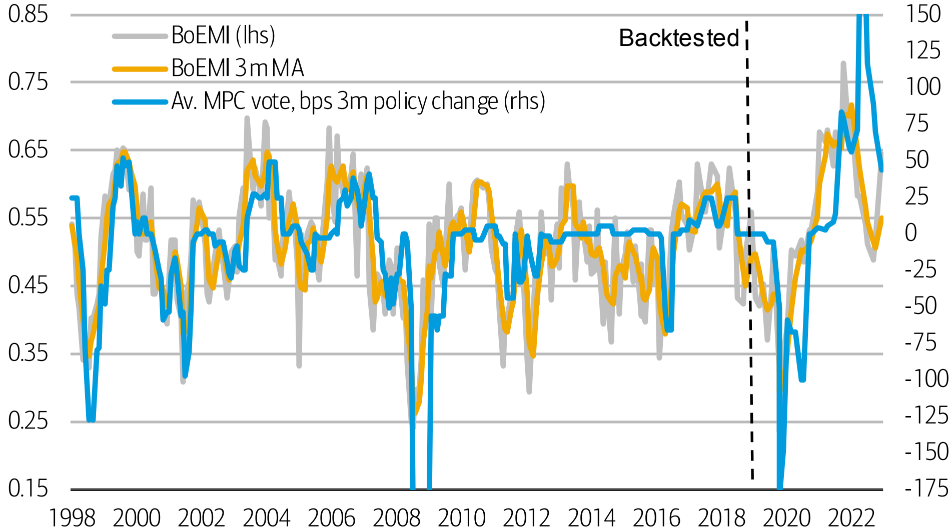
BoE expects very soft landing

The big picture from the BoE's forecasts, in our view, is that they now expect a very soft landing. No recession, annualised growth close to potential from mid-2023, unemployment peaking at 4.5% and inflation falls 900bp from its peak to a low point 20bp below the 2% target. This can add up of course. The BoE thinks the inflation neutral unemployment rate is in the low 4s, so 4.5% would imply some small degree of slack. The BoE argues that its models suggest almost all of the acceleration in wage growth is a response to spot inflation, so wage growth will drop back sharply as headline inflation drops.

The economic scenario hangs together, but we would argue it is optimistic. The UK has experienced the greatest acceleration in wage growth and the strongest evidence, in our view, of inflation expectations deanchoring modestly to the upside. We think the UK has an inflation persistence problem. We have therefore been arguing the risks of fewer rate cuts than the two we expect in 2024. With the BoE also potentially pausing at a lower terminal than the market to hold there for longer, we take the opportunity to remove a cut from 2024. We now expect one cut only, in 3Q 2024. In sum we raise our end-2024 Bank Rate forecast to 4.5% from 4.0%.

Exhibit 1: BofA Bank of England Mood Indicator

Much more hawkish BoE



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Rates: firmer forward real rates required

The UK rates market initially read the BoE's new forecasts as suggesting more rate hikes, increasing the cumulative rate hike pricing to over 45bp after the May meeting. But this hawkish interpretation was revised softer during the press conference.

At the time of writing, the market is pricing 42bp of additional Bank rate hikes after today's meeting, more than our call for additional 25bp in June, but not enough to enter an opposing position, we think.

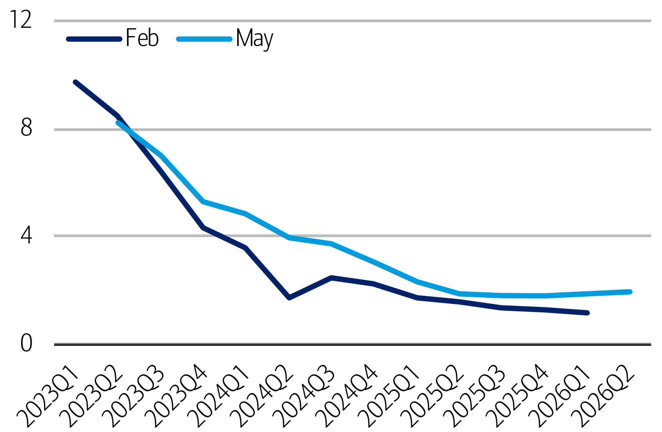
The UK is likely facing the most severe persistent inflation problem among developed market economies, and this means (in our view) that the BoE is likely to cut later and slower than other central banks. We therefore see market pricing of Bank rate cuts after the September MPC meeting as more inconsistent with our latest views.

Further out, the 2s10s curves flattened on the back of midday announcement, unwinding some of the move during the press conference. Flattening pressures resumed later in the session. Our expectation for an additional Bank rate hike in June and a delay to BoE cuts towards year-end is in line with the price action.

The problem with seeking out inflation persistence trade opportunities is that a material inflation overshoot is already priced into the RPI curve. We therefore see the better plays being in the real yield curve - an inflation overshoot is priced, but not the required tightness in (real) policy rates to tackle it, we would argue. Cash-for-cash shortening trades between shorter-dated linkers would be our preferred way of expressing this theme.

The BoE seems to have shifted somewhat towards acceptance of this inflation persistence threat, judging by the dramatic change in its inflation since the February MPR, as shown in Exhibit 2 and Exhibit 3.

Exhibit 2: BoE forecast inflation paths in February and now, %
Inflation persistence seen as a bigger problem now than 3 months ago.



Source: Bank of England

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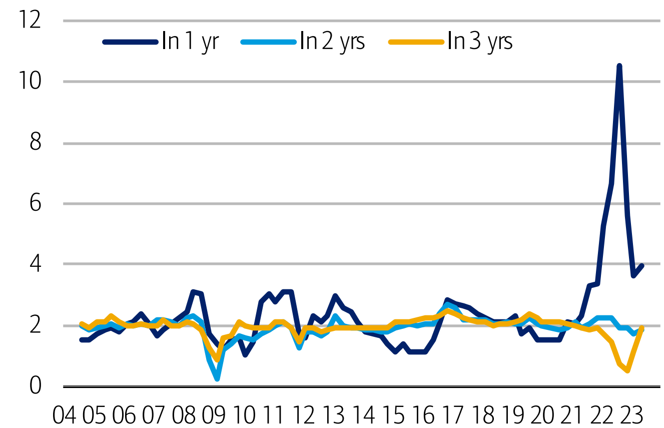
Exhibit 3: BoE forecasts to different horizons, %
Expected target undershoot at three year horizon has disappeared.



Source: Bank of England

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GBP – BoE unlikely to be of much help near term

We think the BoE is unlikely to offer much help to GBP in the near term, particularly vs. EUR, given the market is pricing a higher terminal rate for the BoE vs. our baseline, but a lower one for the ECB. This is not to say monetary policy cannot help GBP later in the year—our economists expect fewer rate cuts from the BoE than from the ECB next year, whereas markets are pricing a more symmetric stance. Ultimately, this will depend on how sticky inflation proves and why: inflation persistence on idiosyncratic issues around the supply side of the UK labour market (as our economists have highlighted) won't probably help GBP much. But inflation persistence on an improved outlook—much as in recent months—could help GBP, risk-sentiment permitting. We would flag we now find the investor EURGBP positioning neutral vs. long at the start of the year, with this change driven primarily by Hedge Funds.

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