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Liquid Insight

Bank of England preview: extended hold

01 November 2023

Rates and Currencies Research
Global

Key takeaways

- We expect the BoE to keep Bank Rate unchanged this week, in a 7-2 vote. Inflation and growth have surprised dovishly.
- Near-term growth and inflation forecasts cut, raised in medium-term. Inflation likely forecast at 2.0% in medium-term.
- FX: rate differentials are back on the radar for GBP investors for now. Rates: we expect more clarity on QT "bucket" tweaks.

By Robert Wood, Mark Capleton, Kamal Sharma & Agne Stengeryte

Chart of the Day: Inflation surprised the BoE dovishly
CPI inflation, data, BoEf and BofAf shaded

	Headline		Services	
	BoEf	Data/BofAf	BoEf	Data/BofAf
Jun-23	7.9	7.9	7.2	7.2
Jul-23	6.8	6.8	7.3	7.4
Aug-23	7.1	6.7	7.2	6.8
Sep-23	6.9	6.7	7.0	6.9
Oct-23	5.0	4.9	6.8	6.8
Nov-23	4.8	4.7	6.8	6.8
Dec-23	5.0	4.6	6.9	6.8

Source: BofA Global Research, BoE, ONS

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In our view the Bank of England's (BoE) high bar to a hike at Thursday's policy meeting has not been breached. Inflation (see Chart of the Day) and growth have been weaker than the BoE expected. Wage growth has surprised no further on the upside than last month. Uncertainty about the labour market data suggests BoE caution. We expect a 7-2 vote to hold. Afer investing effort to get the market to price a 'table mountain' path for rates, we expect the BoE to forecast inflation (on mean forecasts) at target in 2-3 years.

We expect the BoE to be on a very extended policy pause now, with the first rate cut not until February 2025. With the labour market easing gradually and growth weak, the bar for further hikes is probably high. Equally, unwinding labour market imbalances and bringing inflation sustainably back to the target will take time, in our view.

Global Rates & Currencies Research
MLI (UK)

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

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

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

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

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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BoE to hold rates

At their last policy meeting we think the core rate setters at the BoE communicated a strong preference to keep interest rates on hold (see our report: UK Watch: Bank of England review: none and done, probably 21 September 2023). While the BoE set a high bar to a further hike it continued to emphasise data dependency.

> "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...
>
> 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."
>
> (Minutes of Bank of England September policy meeting).

Data have mostly surprised dovishly since September, so we expect the BoE to keep interest rates on hold at Thursday's policy meeting. Services price inflation has been weaker than the BoE forecast (Chart of the Day) and unemployment 0.2ppt higher than expected. Wage growth has exceeded BoE forecasts, but by no more than in the data available for the last policy meeting (UK Watch: Pay growth peaked 17 October 2023) and remember the BoE downplayed official wage data at its last meeting. Revisions to labour market data since then suggest caution on labour market slack. "Resilience in the economy as a whole" also seems to have surprised dovishly. PMIs – watched closely by the BoE – suggest the economy slowed to a standstill or contracted mildly in 3Q 2023.

7-2 vote likely

The four rate setters who preferred a 25bp hike last month referenced consumer sentiment holding up and forward-looking indicators of output as reasons to discount the weaker headline PMIs. The weakening of those indicators could shift some hawks to preferring no change. But their other concerns remain, with wage growth and services inflation above rates consistent with meeting the 2% inflation target sustainably.

On balance, we look for a 7-2 vote to keep rates on hold compared to 5-4 last month. We assume Jon Cunliffe's replacement, Sarah Breeden, votes with the majority for no change. We assume one of Mann, Haskel or Greene – the other previous voters for a 25bp hike – switch to hold also. We assume a switch is most probable for Greene and least for Mann.

We expect little change to the BoE's guidance. We see a risk that it reduces the importance of the indicators of persistence in its guidance language or tweaks the sentence to increase the focus on measures of slack and growth.

Cut growth and inflation near term, raise medium term

We expect the BoE to cut near-term growth and inflation forecasts, mirroring the weaker data flow (Exhibit 1). We think it will include a small output fall in 3Q 2023. Meanwhile, we expect the Bank to raise growth and inflation forecasts at the two- and three-year horizons, reflecting lower market policy rate expectations and lower sterling. We expect the BoE to forecast inflation at or very close target at the two- and three-year horizon, essentially validating market expectations. After investing considerable effort to communicate, and convince the market of, a 'table mountain' path for rates as BoE Chief Economist Pill put it, we think the BoE will make the forecasts consistent with that message. A risk to our call is inflation sags below 2% at the end of the forecast, suggesting faster cuts when the BoE starts. But we think it's too soon for that message.

Uncertainty this month comes partly from the BoE's annual review of the supply side of the economy. We expect that to result in a higher inflation neutral unemployment rate (NAIRU), so higher unemployment forecasts do not translate into lower inflation. But the BoE could instead use a NAIRU increase to bring some upside inflation risks into the central case, raising the modal forecasts relative to the mean. The supply stock take may have been complicated by the recent revisions of labour market data and the increased uncertainty in those figures.

Exhibit 1: Cut growth and inflation near term, raise medium term
BofA forecasts of mean BoE forecasts in November Monetary Policy Report

BofA forecast for Nov MPR (Aug MPR figures in parentheses)

	GDP % yoy	Inflation	Unemployment	AWE
2023 4Q	0.5 (0.9)	4.8 (4.9)	4.3 (4.1)	6.5 (6)
2024 4Q	0.1 (0.1)	3.1 (2.8)	4.7 (4.5)	4.0 (3.5)
2025 4Q	0.7 (0.6)	2.0 (1.9)	5.0 (4.8)	2.5 (2.5)
2026 4Q	1.3	2.0	4.9	2.5

Source: BofA Global Research, BoE

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Policy tightening vs. real wage growth and persistence

The BoE's new forecasts should tell a story of restrictive policy balancing improving real wage growth and second-round effects from the recent inflation surge. Persistently restrictive rates gradually return inflation to target without causing a recession. It's a forecast of policy 'just right'. In our view, this leaves a high bar to hike rates further. They will want to emphasise, we suspect, "sufficiently restrictive for sufficiently long."

In our view, the UK has a greater inflation persistence problem than other major economies as discussed in our note linked here UK Viewpoint: Market challenges to the Bank of England 31 October 2023. Accordingly, we expect the BoE to keep interest rates on hold in restrictive territory for an extended period. We see no more rate hikes, but no rate cuts until February 2025, when we expect four that year.

The market more or less prices in our central case, with a first cut fully priced by 4Q 2024 and approximately four cuts by end-2025 (based on the 15 working day average of market prices used by the BoE). We see two-sided risks. If the recent growth slowdown turns out to be a blip, perhaps caused by waning fiscal support before real wage growth picked up, inflation might take longer than the BoE expects to return to target. On the other hand, recent weaker growth could be a sign that monetary policy is having a larger effect than we assume. The economy could enter recession, raising labour market slack faster and bringing down inflation quicker. On balance, we see the risks to our call for the BoE to stay on hold until 2025 as skewed towards an earlier rate cut.

FX: A semblance of normality

A key part in our narrative on GBP price action through Bank of England meetings has been the argument that monetary policy was a secondary driver to sterling moves compared to idiosyncratic risk premium. Our analysis suggests that there has been an inflexion point in that relationship. As the market has continued to price out worst case scenarios for the UK, tail risks have receded, and GBP has now once again recalibrated to some of its long-standing relationships. This makes GBP price action around rate decisions more responsive than it was at the start of the year. The UK rates market now believes that UK rates have peaked. This is not the news that will move GBP. Rather, with the market now pricing in the first cut through September/ October 2024, the macro/rate forecast profile will likely provide the new information for potential GBP moves. Given our expectations on the timing of the first rate cut, any confirmation from the BoE could provide some support for GBP if it triggers some rate recalibration. Positioning according to our metrics should not provide a barrier to an FX response. But our bottom line here is that GBP can now be viewed as a conventional G10 currency once more. Whether this will prove to be unstable equilibrium in the longer-term remains to be seen and 2024 is shaping up to be another interesting year with UK elections and the focus on UK fiscal dynamics.

Rates: One step closer to QT "bucket" tweaks

We expect the BoE to use November's Monetary Policy Report (MPR) as an opportunity to outline the case for a skew shorter in its "active" Gilt sales, before a formal announcement of the amendment for its 1Q24 Gilt sales plan (at 4.30pm on 15 Dec).

In September, the relevant paragraph of the Asset Purchase Facility (APF) Market Notice - repeated in every Market Notice since APF sales began - was expanded to include monitoring of whether the current approach of selling Gilts evenly across maturity sectors remains appropriate. The addition suggested to us that the BoE was explicitly considering the even split and could amend at any quarterly announcement.

While we were not expecting the BoE to skew Gilt sales shorter in September (and do not expect before 15 December), we thought they should, and saw it as an under-priced possibility (BoE preview: one more hike and done, 20 Sep). Our reasoning then:

- The Bank has been selling Gilts with equal amounts in the same 3-7y, 7-20y and 20y+ buckets that it used to buy them. The passage of time and the Gilt market sell-off means that the weighted average maturity (WAM) of the Quantitative Easing (QE) portfolio has collapsed.

- Although the Bank measures changes to the stock of QE in original purchase cost terms, sales are conducted in equal market value amounts in each bucket. The Bank is therefore doing far more QT at the long end, because it is selling those Gilts at less than half their cost.

- This means that the Bank is selling a disproportionately large share of longs. For a telling comparison, consider the following: the market value of 1-3y APF Gilts, at £172bn, now exceeds the total value of 20y+ APF Gilts (£99bn).

We would add a new argument, that current conditions at the long end of the market (in the UK and elsewhere) make it harder for the Bank to continue to argue that QT is operating "in the background".

QT aside, we will be looking for any hints about Bank rate cut pricing. The front-end curve in the UK is now the most mispriced relative to our base case in the UK, Europe and US, in our view, and does not appear to be fully warranted by economic developments and stands in contrast to our BoE rate call for 2024-2025 (no cuts in 2024, 100bp of cuts in 2025).

We have more confidence in fading Bank rate cuts in 2024 than in positioning for more cuts being priced in for 2025. Pre-election fiscal stimulus measures in the Spring Statement could be one reason for pricing out rate cuts in 2024. "Higher for longer" implies the possibility of fewer Bank rate cuts than the 100bp we expect in 2025, if they begin later than we anticipate.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The needle could easily move**, Global FX Weekly**, 27 Oct 2023
- Haunted fiscal house, **Global Rates Weekly**, 27 Oct 2023
- Yielding to official pressure, **Liquid Cross Border Flows**, 23 Oct 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: The needle could easily move 27 October 2023

Global Rates Weekly: Haunted fiscal house 27 October 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

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

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com

W