UK Watch

Bank of England Preview: extended hold

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We expect BoE to hold rates next week

In our view the Bank of England's (BoE) high bar to a hike at next week's meeting has not been breached. Inflation 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 suggest BoE caution. We expect a 7-2 vote to hold.

Sluggish growth, inflation at target, on lower yield curve

The BoE looks likely to cut its near-term growth forecasts because of weak recent data. But lower market policy interest rate expectations and weaker sterling should boost growth in the medium term. We expect the BoE to keep GDP growth little changed over the 3-year forecast as a whole. We assume no major adjustments in response to longer term yield rises.

Medium-term inflation at target

Weaker-than-expected inflation data should cut near-term BoE forecasts 10bp, taking the 4Q 2023 number to 4.8%. But we expect the BoE to raise its two- and three-year ahead forecasts 0.1ppt to 2% as weaker near-term growth and higher unemployment are offset by lower sterling, higher gas prices and a higher inflation-neutral unemployment (NAIRU) rate. The forecasts should tell a story of restrictive policy doing just enough to offset improving real wage growth and second-round effects.

Policy tightening vs real wage growth and persistence

We expect the BoE to be on a very extended policy pause now, with the first rate cut not until February 2025. As inflation persistence has stopped surprising, the BoE is now focusing more on growth and slack. With the labour market easing gradually and growth weak, we think the BoE will conclude that policy is about right for now. 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.

FX: A semblance of normality

GBP has shown increasing signs of reverting back to its long standing relationship with UK rates. GBP is now more responsive to the BoE rate decision than it was at the start of the year as idiosyncratic tails risks have been priced out. Positioning provides little obstacle to a GBP reaction: the BoE is on hold – what and when it moves after that will be the key for GBP. Pricing out of 2024 rate cuts could provide support for GBP.

Rates: One step closer to QT "bucket" tweaks

We expect the BoE to use November's Monetary Policy Report 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 on 15 Dec.

Refer to important disclosures on page 8 to 10. 12617347

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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]). Meanwhile, data have mostly surprised dovishly since, so we expect the BoE to keep interest rates on hold at next week's policy meeting.

While the BoE set a high bar to a further hike, in our view, it continued to emphasise data dependency in its guidance last month.

> "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).

Services price inflation has been weaker than the BoE forecast (Exhibit 1) 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]). The BoE downplayed the official wage data at its last meeting, arguing other indicators were weaker. Revisions to labour market data since then suggest further caution on wage growth and labour market slack.

Exhibit 1: Inflation surprised the BoE dovishly
BofAf and BoEf CPI inflation

	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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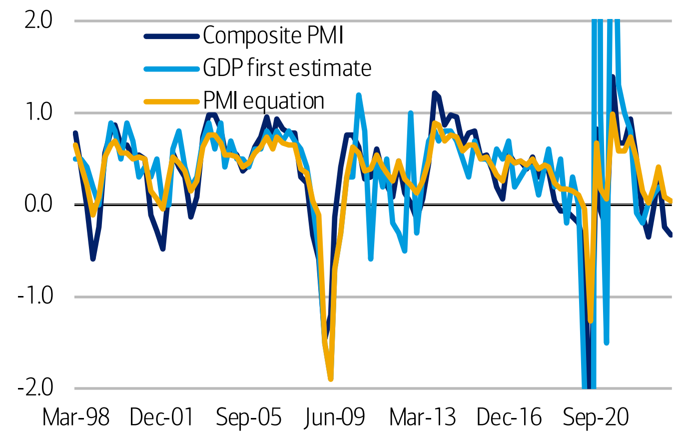
Exhibit 2: Economy slowed to standstill or small contraction
GDP growth, % qoq, and PMI signal



Source: BofA Global Research, S&P Global, ONS

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"Resilience in the economy as a whole" also seems to have surprised dovishly in our view. PMIs – watched closely by the BoE – suggest the economy slowed to a standstill or contracted mildly in 3Q 2023. We are tracking -0.1% qoq growth, below the BoE's forecasts of 0.3% qoq in August and 0.1% qoq at the time of the September policy meeting. Forward looking indicators from the PMI – business expectations – have weakened. Other surveys do not suggest an outlook as weak as the PMI. Nonetheless, the growth news has been dovish.

Taken together, we think this data flow points to a very high probability that the BoE keeps interest rates on hold. However, the vote split seems harder to judge. 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 at rates above those consistent with meeting the 2% inflation target sustainably.

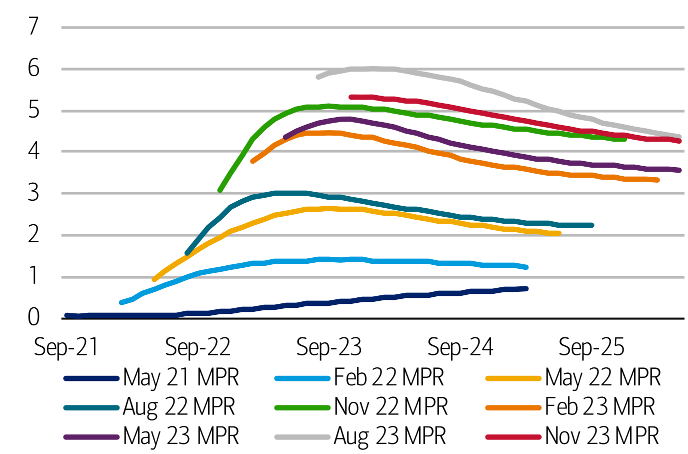
On balance, we look for a 7-2 vote to keep rates on hold compared to 5-4 last month. We assume Jon Cunliffe's replacement, Sarah Breeden, votes with the majority. We assume one of Mann, Haskel or Greene – the other previous voters for a 25bp hike – switch to hold also. We have relatively limited information, given infrequent public appearances, but we would assume a switch is most probable for Greene and least for Mann, who has spoken frequently and seems hawkish to us.

We expect little change to the BoE's guidance, and suspect it wants to continue to emphasise "sufficiently restrictive for sufficiently long". 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

The BoE's forecasts will be conditioned on lower market interest rate expectations and sterling. The market has cut its expected path for Bank Rate by an average of 63bp over the first half of the BoE's forecast (Exhibit 3), enough on standard multipliers to boost growth 0.5% yoy in the second half of the forecast. Lower sterling could add 10-20bp to inflation over that period (Exhibit 4). The BoE will also need to take account of a higher natural gas curve. Oil prices should already be incorporated in the near-term inflation outlook.

Exhibit 3: Market Bank Rate expectations cut in the near-term
Market pricing for Bank Rate



Source: BofA Global Research, BoE

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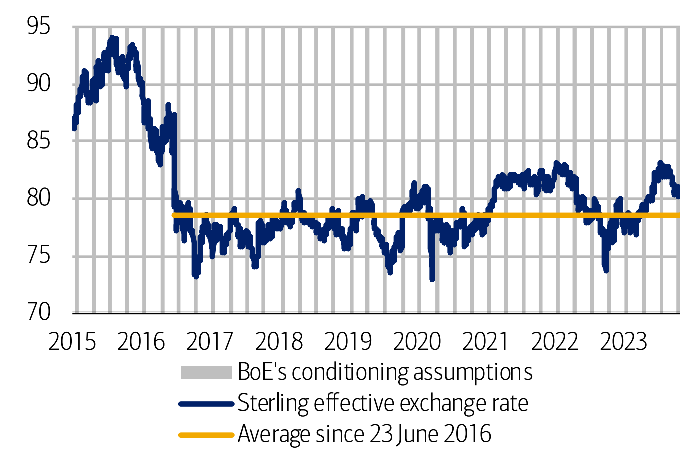
Exhibit 4: Sterling 2.4% weaker than last Monetary Policy Report
Sterling effective exchange rate



Source: BofA Global Research, Bloomberg

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We expect the BoE to cut near-term growth and inflation forecasts, mirroring the weaker data flow (Exhibit 5). 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 interest rates and lower sterling in part. We expect the BoE to forecast inflation at target at the two- and three-year horizon.

Weaker near-term growth will combine with higher-than-expected unemployment data to raise the BoE's unemployment forecasts. But we also expect the Bank's annual review of the supply side of the economy to conclude that NAIRU has risen perhaps by a quarter of a percentage point or more. That would mean the higher unemployment forecast translates into the same labour market tightness (unemployment relative to the NAIRU) as in the last set of forecasts. We see a risk that the BoE uses an increase in the NAIRU to bring some inflation upside risks into the central case, raising the modal forecasts relative to the mean. Note Exhibit 5 shows the mean BoE forecasts.

The supply stock take may have been complicated by the recent revisions of labour market data, and the increased uncertainty in those figures. Given that uncertainty, it may be hard for the BoE to come to strong conclusions about the degree of labour market slack and the NAIRU. We think this would also argue for little change to estimates of labour market slack.

Exhibit 5: 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

These 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. It's a forecast of policy 'just right'. Restrictive policy keeps growth below potential of about 1% a year for much of the forecast but does not cause a recession. The BoE 'trades off' that output weakness against inflation above target until 2025, as it should following a supply shock.

In our view, this leaves a high bar to hike rates further. As inflation has stopped surprising, the BoE has shifted from 'inflation persistence fighting' towards focusing on measures of slack and growth as leading indicators of medium-term inflation. These will tend to be slower moving and are in any case heading in the 'right' direction to return inflation to target. Labour market slack is rising and growth is weak. We suspect the BoE would need to see large data surprises to change rates. They will want to emphasise, we suspect, "sufficiently restrictive for sufficiently long."

UK has greater persistence problem than major economies

In our view, the UK has a greater inflation persistence problem than other major economies. Wages and inflation expectations suggest to us modest deanchoring. We suspect the NAIRU has risen and we argue the effect of monetary policy on growth and inflation is lower than in the past (UK Viewpoint: Entrenched inflation = high for long 01 September 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 pretty much 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 supply before real wage growth picked up, inflation might take longer than the BoE expects to return to target. It may even reaccelerate at some point next year as direct and indirect energy effects (soon to be negative) fade and strong wage growth continues to feed through. Wage growth would need to approximately halve to be consistent with sustainably hitting the inflation target. The BoE may have to hike further, although we think that's unlikely.

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. However, we see a cut as unlikely in the first half of 2024, absent a sharp growth downturn. Inflation will just be too high and we suspect growth weakness too tentative to lead the BoE to quickly reverse course.

FX: A semblance of normality

A key aspect of 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 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 once again recalibrated to some of its long-standing relationships. This makes GBP price action around rate decisions more responsive than at the start of the year. The UK rates market now believes 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 the bottom line here is that GBP can now be viewed as a conventional G10 currency once more. Whether this will prove to be an 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:

Old paragraph - Market Notice 1 Sep

> *"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."*

New paragraph - Market Notice 21 Sep (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****."*

The above 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".

Exhibit 6: Terminal rate implied by Sonia forwards, %
Some 10bp lower since September MPC

Source: Bloomberg, BofA Global Research

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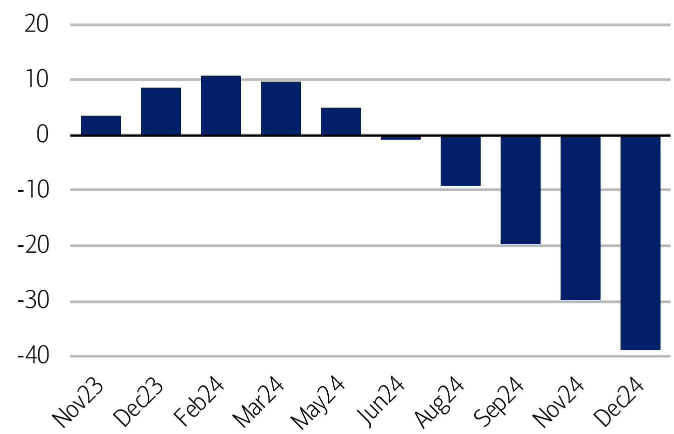
Exhibit 7: MPC-dated Sonia Bank Rate hike expectation, bp
Cumulative 11bp of hikes priced in ahead



Source: Bloomberg, BofA Global Research

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Front-end curve steepening in contrast to our call

Front-end curve steepening since late September does not appear to be fully warranted by economic developments and stands in contrast to our Bank rate call for 2024-2025.

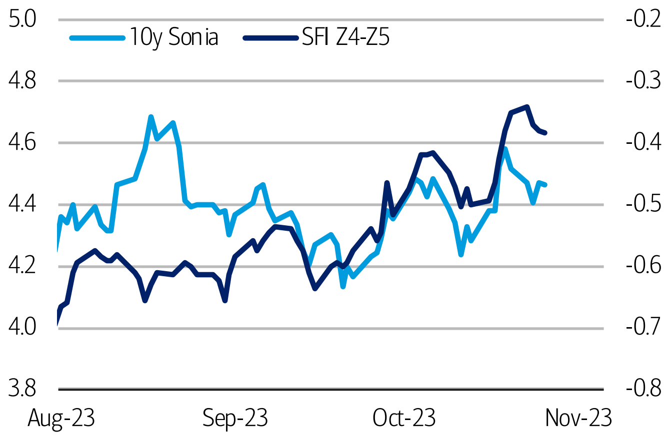
Market took out around 10bp of terminal rate pricing since September MPC (Exhibit 6), now implying a relatively limited probability of the BoE hiking ahead (cumulative 11bp by Feb 2024 – Exhibit 7). This is broadly in line with our view that the BoE stays on hold at 5.25%. On the curve, market priced out around 8bp of cuts from 2024 and 20bp of cuts from 2025, now pricing around 50bp and 40bp of cuts in 2024 and 2025, respectively. In contrast, we expect no cuts in 2024 and 100bp in 2025.

Front-end curve steepening in a rates selloff – modus operandi at the front-end since late September (Exhibit 8) – makes sense if the move higher in rates is driven by upside surprises in data. But inflation and growth have been weaker relative to BoE's expectation, and wage growth surprise was not larger than in September. At least to some extent the selloff has been US-led: our EUR rates team highlighted last week that

Bund selloff of the week prior was all in US hours, with Bunds rallying in London mornings (Hi 5s, 20 Oct). Front-end curve in the UK is now the most mispriced relative to our Bank rate calls in the UK and Europe, US (Exhibit 9).

Exhibit 8: Sonia futures curve vs. 10y Sonia, %

3m Dec'24/Dec'25 curve steepening in a rate selloff



Source: Bloomberg, BofA Global Research

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Exhibit 9: BofA Bank rate cut expectation vs. futures pricing, bp

Sonia futures pricing most out of line versus our expectation

BofA (bp)	Q4 2024	Q4 2025
Fed (upper)	-75	-100
ECB depo	-75	-100
BoE	0	-100
Futures (bp)	**Z4**	**Z5**
SFR	-80	-39
ER	-73	-34
SFI	-52	-39
BofA vs. futs	**2024**	**2025**
Fed	5	-61
ECB	-2	-66
BoE	52	-61

Source: Bloomberg, BofA Global Research

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