Liquid Insight

Bank of England preview – starting a pivot

31 January 2024

Rates and Currencies Research
Global

Key takeaways

- BoE guidance should change slightly, starting a slow pivot towards cuts. Forecasts should still show sticky inflation.
- Rates: Dovish market interpretation possible. FX: BoE push back of current market pricing should be +ve GBP

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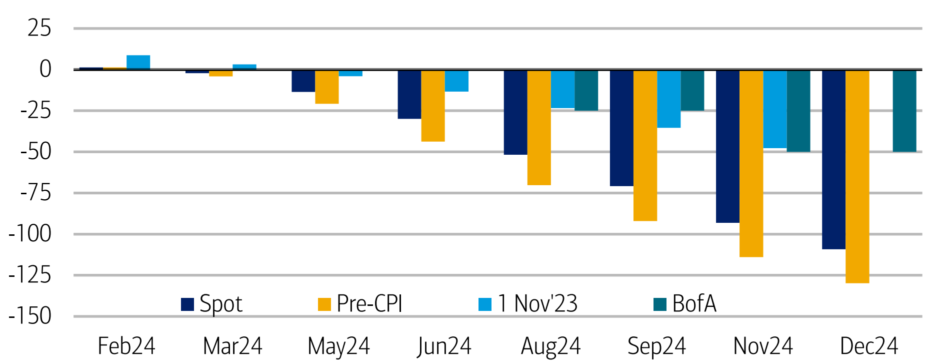
Exhibit 1: MPC-dated Sonia Bank Rate hike exp. vs. BofA forecasts, bp
First 25bp cut priced in by June MPC



Source: Bloomberg, BofA Global Research

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How to balance a pivot while pushing back

We expect the Bank of England (BoE) to keep the Bank Rate unchanged at next week's policy meeting with a 1-7-1 vote in favour. Guidance will likely change slightly, starting a slow pivot towards cuts down the line, but not imminently. At the same time, forecasts should still show sticky inflation. While we would expect the hiking bias to go away, we think the BoE is likely to maintain that "monetary policy would need to be sufficiently restrictive for sufficiently long".

The beginning of it all

Indeed, next week's Bank of England meeting should mark the beginning of a slow pivot towards a cutting cycle that should start in August and proceed slowly. We would argue that the BoE is unlikely to find that "material progress had been made in returning inflation to the 2% target sustainably" and hence we think it is unlikely to pivot strongly towards a cut. Still, the latest data since the BoE's last meeting suggest significant progress in returning inflation to target and this is likely to be reflected in the new forecasts, near term, and with slight changes in guidance.

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It should also be reflected in the vote. While it is a close call, on the margin, we would still expect one vote for a hike and a first vote for a cut. Small deviations from that are also likely.

A gentle pushback

The inflation forecasts should come down in a clear way for this year and next, mainly due to much lower energy prices. But medium term, BoE inflation forecasts may need to remain stickier, to show some (gentle) rebuff vs early cuts. This would signal that market pricing may not be consistent with inflation reaching the target at the traditional two-year horizon for monetary policy. At the same time, with constant interest rates, we would expect some undershoot to target. The implicit signal would be one of a market that has moved too fast.

Small changes to guidance

We would expect guidance to move away, even if at least partially, from a hiking bias. We think the easiest way would be to remove the following phrase: "Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures. " Alternatively, the language could be softened or qualified.

On the other hand, we would still expect the following phrase to be maintained in the minutes as a way of additionally pushing back towards too aggressive a loosening of financial conditions: "Monetary policy would need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term".

Still the last, still slow

Remember we still expect the BoE to keep the Bank Rate on hold at 5.25% until August, and we expect a cutting cycle of 25bp per quarter from there. The UK will be the last of the major central banks to start and it is likely to move more slowly, at least compared with the ECB. The UK still has a bigger persistent inflation problem, despite recent improvements.

BoE forecasts: energy prices to the rescue

The February MPR inflation forecasts should come down in a clear way this year and the next, mainly due to much lower energy prices (Exhibit 1). We assume that the BoE would incorporate some significant adjustments in the Ofgem caps in April/July (press reports suggest a 16% drop in April, followed by an additional drop in July too).

Lower headline inflation should also boost consumer balances and growth – we see 1Q25 growth being upgraded to 0.8% yoy, with the 1Q26 forecasts at 1.1% yoy. Medium term, BoE inflation forecasts may need to remain stickier (both in 2025 and 2026), to show some (gentle) rebuff vs early cuts. For 1Q27, we pencil in 1.4% growth (broadly consistent with trend) and inflation still slightly above the target (2.1%).

Exhibit 2: Lower inflation near-term, sticky medium-term
BofA forecasts of mean BoE forecasts in November Monetary Policy Report

	BofA forecast for Feb MPR (Nov MPR figures in parentheses)	
	GDP % yoy	Inflation
2024 1Q	0.1 (0.2)	3.7 (4.4)
2025 1Q	0.8 (0.0)	2.3 (2.8)
2026 1Q	1.1 (0.6)	2.2 (2.2)
2027 1Q	1.4	2.1

Source: BofA Global Research, BoE

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Rates: Dovish market interpretation possible

Following a strong rally into the end of 2023, UK rates have retraced partially since the start of the year, with the latest leg on the back of last Wednesday's upside surprise in inflation. The market priced out more than one 25bp Bank rate cut, post-inflation, bringing more balance to the front-end and Monetary Policy Committee (MPC)-dated Sonia pricing closer to our economists' base case.

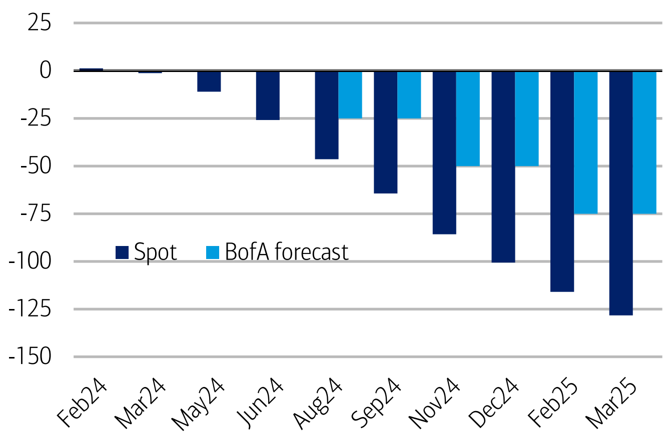
The market is currently pricing in a cumulative 100bp of cuts by December 2024 vs. our base case of 50bp (Exhibit 3). We do not expect a May cut, but the market is pricing in around 11bp of cuts for May MPC (Exhibit 4). We believe this may reflect:

(1) The market believing the BoE will need to cut sooner than its latest guidance: the BoE is viewed as the second most likely central bank to surprise on the dovish side by the end of 2024, after the ECB.

(2) A sharp Ofgem price cap fall in April could push the headline inflation to target in April/May, but April inflation data, to be released on 22 May, will not be available in time for the 9 May MPC meeting. Market belief of a large probability of a June cut after inflation drop would mechanically lead to some probability of cuts interpolated for May.

Overall, our expectations for next week – three-way vote split, guidance moving away from a hiking bias (even if at least partially) and a gentle pushback against market pricing – suggest a bias for the market to interpret things on the dovish side.

Exhibit 3: MPC-dated Sonia Bank Rate hike exp. vs. BofA f'casts, bp
First 25bp cut priced in by June MPC



Source: Bloomberg, BofA Global Research

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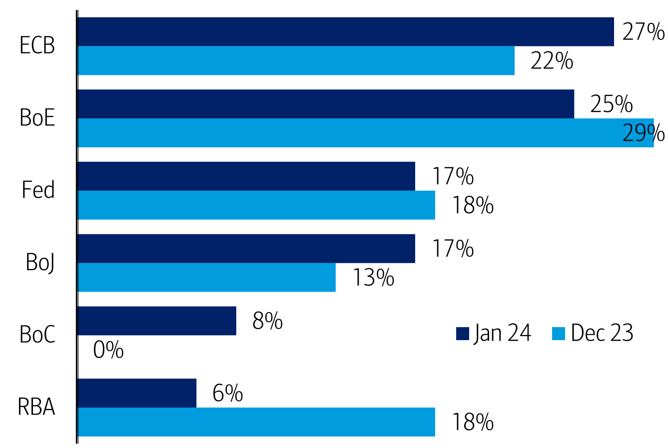
Exhibit 4: Which central bank is most likely to deliver a more dovish outcome by YE 2024 than current market pricing:
BoE seen as second most likely to surprise dovishly



Source: BofA Global Research FX and Rates Sentiment Survey

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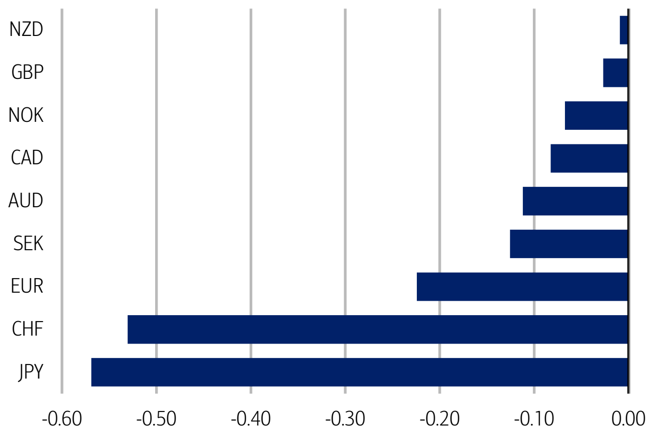
GBP: It's all relative

One of the main narratives behind this year's strong performance for the pound has been carry (Exhibit 5). At a time where many central banks have been guiding markets towards the possibility of near-term rate cuts, the BoE has been steadfast in its view that rates will need to stay higher for longer and rates cuts will be later rather than sooner. Despite our view that the tightening cycle is now at an end and the February meeting will begin the pivot towards an easing bias, we do not think that this will be enough for investors to conclude that rate cuts are imminent. Indeed, we continue to believe that the UK rates markets remains overly optimistic in its expectation for a 25bps rate cut in May. As our UK economists opine above, we would expect the BoE to lean on language that pushes back on current market pricing (Exhibit 5). Admittedly, the BoE has been remarkably quiet since the start of the year in comparison to its peers, so there is a smaller body of evidence to suggest how forceful that pushback will be. We will look to the Bank's forecasts projections under the assumption of current market rates as a guide to how far the MPC is willing to push back on current pricing.

In terms of GBP reaction, with the market still pricing in the chance of early rate hikes, we think the risks are skewed asymmetrically. We doubt that the MPC will validate current market pricing so an unwind of front-end cuts should be constructive for the GBP outlook. Though date remains soft in broader terms, we note the divergence between softer EZ PMI vs stronger UK PMI. UK lead indicators and housing data have in particular shown signs of improvement. Furthermore, developments in the Red Sea are likely to be an unwelcome dynamic for a country already being buffeted by several structural inflationary issues. Furthermore, with the latest public sector borrowing figures undershooting the Office for Budget Responsibility (OBR) forecasts by £14bn and the increase of the National Minimum Wage in April, we think the BoE will likely err on the side of caution to assess the impact of what could be a stimulative Spring Budget before committing to the start of an easing cycle. All-in-all, the backdrop to February's BoE should be supportive for our constructive view on GBP. Caution is thus warranted with the bottom line being a supportive backdrop for further GBP gains.

Exhibit 5: 3mth carry/implied vol ratio vs USD

GBP offers relatively little carry drag vs USD



Source: BofA Global Research, Bloomberg

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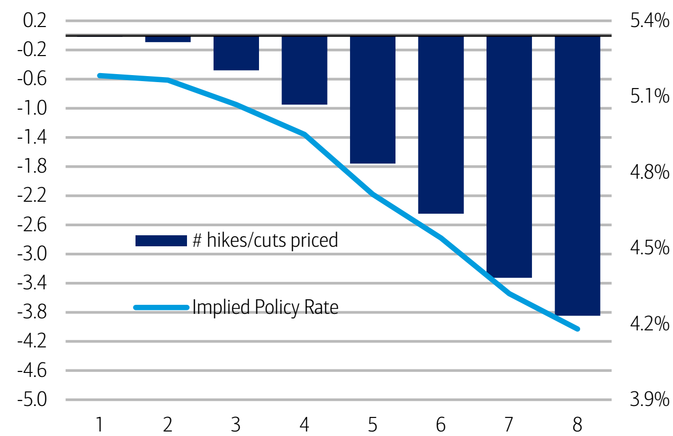
Exhibit 6: OIS Pricing for UK

Market is overambitious for rate cuts this year



Source: BofA Global Research, Bloomberg

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- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Into month-end and the Fed, **Liquid Cross Border Flows**, 29 Jan 2024

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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:

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