BOE
Preview

June 2022

MONEX

Bank of England set to hike by 25bps and continue pushing back on market expectations

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The Bank of England is set to announce its latest policy decision at 12:00 BST on Thursday, with economist and market expectations aligned with our view for a 25bp hike. While there is more dispersion among market pricing relative to economist expectations, the roughly 40% chance that the BoE would hike rates by 50bps, as implied by overnight index swaps, is more representative of limited liquidity and the change in Fed pricing than expectations of the BoE's next move. This should reduce the impact of a more dovish Thursday BoE announcement on UK assets. The market impact of Thursday's decision is, therefore, more likely to be driven by the Bank's forward guidance. Given that the Bank isn't set to publish another set of formal projections until its August 4th meeting, forward guidance will come in the form of meeting minutes and the vote split.

Within the May meeting minutes, the market is likely to focus on two topics...

Firstly, the Bank's view on domestic demand levels will be heavily examined because recent data has pointed towards Q2 GDP growth undershooting the Bank's already bleak projection of +0.1% QoQ and May's services PMI initially entailed a stark drop before being revised higher in the final reading. While much of April's decline in GDP can be attributed to reduced Covid-related spending and renewed weakness in the manufacturing sector, the further erosion of household incomes due to elevated inflation levels only weighs on the outlook for consumer demand going forward. April's labour market data highlighted the challenging environment for households: while weekly earnings excluding bonuses remained elevated at 4.2%, in inflation-adjusted terms workers' wages fell the most in at least 21 years. Once adjusting for the estimated base effects (+0.6pp) due to the furlough scheme, the outlook for households' balance sheets deteriorates further. Adding more fuel to the fire, the historically tight labour market is starting to loosen, as evidenced by the 0.4% 3-month expansion in the labour force, which caused the 3-month unemployment rate to tick up from 3.7% to 3.8%. While the monthly data should be taken with a heap of salt, the jump in the one-month unemployment rate in April from 3.5% to 4.2% could be suggestive of what is to come—a further expansion in the participation rate that prevents wage growth from being dragged much higher by inflation.

That said, the consumer data thus far has held up reasonably better than the Bank of England's May forecasts. This is likely to be reflected in the June meeting minutes.

The Bank's tone around the outlook for consumption will also be improved by the Chancellor's £15bn cost-of-living support package, which is estimated to reduce 80% of the expected increase in energy bills for the most vulnerable households. Given the bleak outlook for real incomes going forward, the Bank's more optimistic tone around consumption levels shouldn't be misinterpreted as a signal that the Bank Rate is set to climb progressively higher over the course of the year as it is still uncertain whether households will draw down on the estimated £170bn in accumulated savings to buffer the cost-of-living crisis.

Market participants will also pay close attention to the **level of dissent over the Bank's previous forward guidance message** within the meeting minutes.

Back in May, "some members of the Committee judged that the risks around activity and inflation over the policy horizon were more evenly balanced and that such guidance (that some degree of further tightening in monetary policy might still be appropriate) was not appropriate at this juncture." An increase in the level of dissent suggests that the Bank is naturally slowing towards its hiking cycle, or at least not pigeonholing themselves into hiking rates should growth conditions quickly deteriorate. A substantially more dovish development would see the Bank shift its core forward guidance message to something signifying a more data-dependent reaction function going forward.

Finally, the Monetary Policy Committee's voting split will be the clearest message to markets as to what the next policy decision is likely to be. Although developments since May suggest the near-term risks to the Bank's inflation forecasts have increased, we expect the vote split to become markedly more dovish on the back of more concerning growth data. Our expectations are for a 2-5-2 split for hold-25bps-50bps. This would be a departure from the 6-3 25bp-50bp split back in May and would see Silvana Tenreyro and Jon Cunliffe voting to hold rates while Michael Saunders and Catherine Mann continue to push for a higher larger move.

The Bank's dovish pushback on market pricing may not have an impact on sterling

Money market pricing has disconnected substantially from the Bank of England's communications. Back in May, the market-implied forecasts within the Monetary Policy Report pushed back on the prospect of an interest rate as high as 2.5% by early 2023, as under this scenario the Bank projected that the inflation would fall substantially below the 2% target to 1.3%. Since the May MPR, the near-term inflation outlook has deteriorated slightly, however, we view the downturn in the UK economic growth outlook as more substantial.

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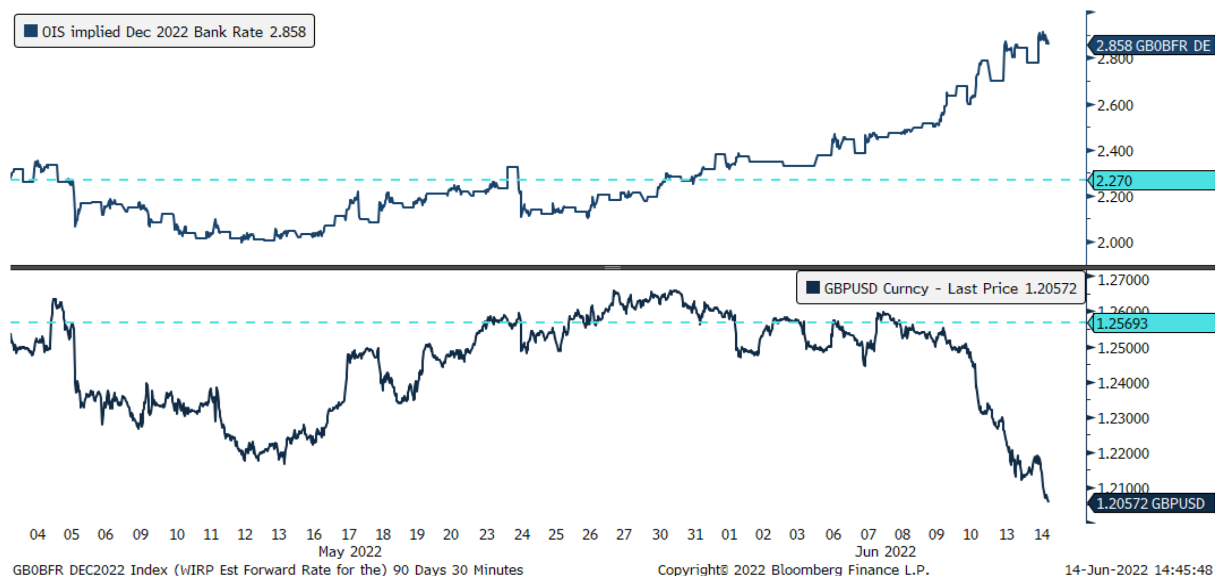
Even though the Bank won't publish a new set of projections, the tone of tomorrow's communications will likely reiterate that market pricing has become too aggressive, considering the mid-2023 implied Bank Rate has since risen from 2.5% to just shy of 3.4%.

> With a **50bp move now priced in by August's meeting**, and a cumulative seven 25bp hikes priced in over the next five meetings until year-end, the scope for a dovish repricing in UK rates is plentiful.

Given the disconnect between the Bank's messaging and market pricing, however, along with the performance of sterling since the May meeting, a dovish repricing in UK rates markets may not induce further GBP underperformance.

Year-end pricing of the Bank Rate has only increased since the May meeting, while sterling has fallen over 4%



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