01 November 2021

UK Research

Bank of England Preview: Unchanged or dovish rate hike

Key takeaways

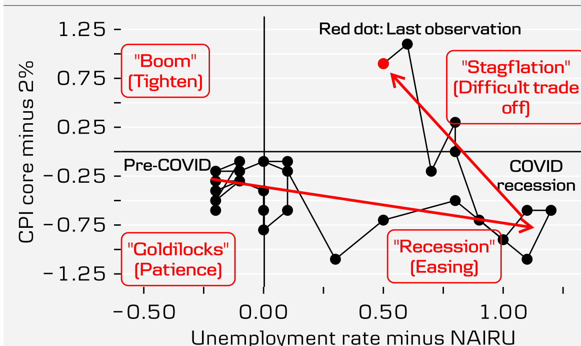
- It is a close call whether the Bank of England (BoE) hikes on Thursday or not. On balance, we expect the BoE to keep monetary policy unchanged.
- If we are wrong, we expect a dovish hike with the BoE saying that the hiking cycle will be "gradual and limited".
- Market pricing is too aggressive pricing in a total of 125bp rate hikes until year-end 2022. We expect a total of 65bp rate hikes from now until year-end 2022.
- FX: EUR/GBP is likely to move higher in case of unchanged policy but also in case of a dovish rate hike, given the very aggressive market pricing.

BoE call: We expect the BoE to keep policy unchanged but risk is tilted towards a dovish rate hike

The Bank of England (BoE) meeting on Thursday 4 November is going to be a key market mover this week. What was unthinkable in the beginning of the year, is now a real possibility. Will the BoE raise the Bank Rate or not? Investors have more or less fully priced in a 15bp rate hike while economists are evenly divided between unchanged and a 15bp rate hike. The sudden hawkish shift in September was a major driver of higher yields also in Europe, so BoE's policy decision is also going to be interesting from a broader market perspective.

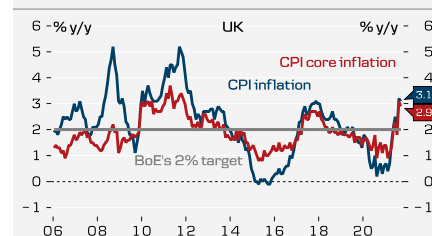
Like other central banks, the Bank of England find themselves in a difficult situation. On one hand, inflation is high with headline inflation above 3% and core inflation close to 3%. Unlike e.g. the ECB, the BoE did not struggle to the same extent with too low inflation and hence the room for patience with high inflation is probably lower. Inflation expectations have risen but data is mixed depending on the source. On the other hand, total employment remains subdued and real GDP is lower than in Q4 19 (and much lower than if GDP had followed the old trend path). It is, however, difficult to interpret the labour market due to a combination of a smaller labour force and many unfilled vacancies.

The Bank of England is in a difficult situation, just like other central banks



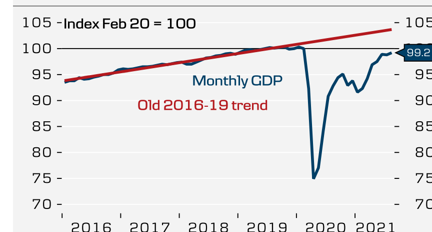
Sources: ONS, Macrobond Financial, Danske Bank

Inflation is well above the 2% target



Sources: ONS, Bank of England, Macrobond Financial

GDP remains below its level in February 20 and well below the old trend path



Sources: ONS, Danske Bank trend, Macrobond Financial

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So what does this mean? Our base case is that the Bank of England keeps monetary policy unchanged but it is a close call. In our view, there are two hawkish BoE policymakers (Saunders and Ramsden), two with a hawkish tilt (Pill and Bailey), two neutral (Broadbent and Cunliffe) and three doves (Mann, Tenreyro and Haskel). So the decision basically depends on what Broadbent and Cunliffe think (assuming the hawkish and hawkish leaning policymakers vote in favour of a rate hike) and unfortunately we have not heard from them since the last meeting in September. Cunliffe has, however, voted against a rate hike previously, back in November 2017.

Bank of England has not pushed back on market pricing, but to some extent it probably also reflects that BoE policymakers have very different views on the economy. It is much more difficult for central banks to communicate to markets when policymakers disagree on the fundamental analysis of what is going on.

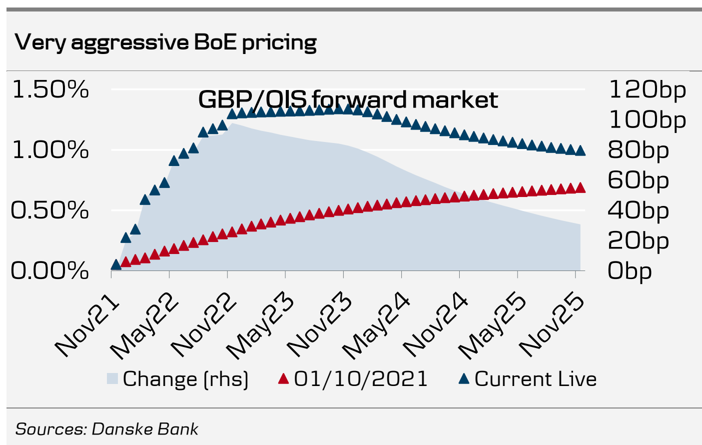
If we are wrong, we expect a dovish hike, as we expect the BoE to say a hiking cycle will be "gradual and limited". This would be a clarification compared to the Monetary Policy Report from August, which said that *"some modest tightening of monetary policy over the forecast period was likely to be necessary"*. At least we expect the Bank of England to repeat this message. A dovish rate hike is probably also what is needed for the hawks to get support from neutral and dovish BoE policymakers.

Markets are pricing in very aggressive rate hikes from the Bank of England until 2022 (a total of 125bp rate hikes from now until year-end 2022), which we believe is wrong – and at least very different from what the Bank of England communicated at the last meeting. We expect a total of 65bp rate hikes on the same horizon. It is also notably that markets are pricing lower rates starting from 2024.

FX: EUR/GBP likely to move higher near-term on unchanged policy or dovish hike

We see a case for EUR/GBP moving higher near-term in response to either unchanged policy or a dovish rate hike, given the aggressive market pricing. We expect the move higher in EUR/GBP will be short-lived. We still expect rate hikes from the Bank of England, while we expect the ECB to stay patient despite recent increases in rate hike expectations, see *ECB Review: Confirmed: Today's meeting was a prelude to December*, 28 October. Also we still believe the environment is more supportive for GBP than EUR, as GBP usually strengthens in an environment where USD does. That said, the potential for a stronger GBP is lower than for USD. We still target EUR/GBP in 0.83 12M.

Very aggressive BoE pricing



Sources: Danske Bank

Recent BoE communication

Stance	Name	Recent comments	Vote in September
Hawkish	Michael Saunders	"But markets have priced in over the last few months an earlier rise in Bank Rate than previously and I think that's appropriate" (October)	Voted in favour of early QE stop
	Dave Ramsden	"I can envisage those conditions for considering tightening being met somewhat sooner than I had previously expected" (July)	Voted in favour of early QE stop
Hawkish tilt	Huw Pill	Next meeting is "live" and rate hike decision is "finely balanced" (October); hinted at a a less aggressive hiking cycle than markets are pricing	Unchanged
	Andrew Bailey	"Have to act and must do so if we see a risk, particularly to medium-term inflation and to medium-term inflation expectations" (October)	Unchanged
Neutral	Ben Broadbent	Nothing on monetary policy since the last BoE meeting	Unchanged
	Jon Cunliffe	Nothing on monetary policy since the last BoE meeting (voted against rate hike in November 2017)	Unchanged
Doves	Catherine Mann	"I can wait on active tightening through a Bank Rate rise" (October)	Unchanged
	Silvana Tenreyro	"Typically, for short-lived effects on inflation, such as the big rises in the prices of semiconductors or energy prices, it would be self-defeating to try to respond to their direct effects"	Unchanged
	Jonathan Haskel	"For the foreseeable future, in my view, tight policy isn't the right policy" (July)	Unchanged

Sources: Bloomberg, Reuters

The economic situation – an overview

GDP growth

Monthly GDP continues to increase but it is fair to say that the "easy" part of the economic recovery is now completed. The uncertainty surrounding the economic outlook has risen, as we are likely to see new COVID-19 outbreaks both in Europe (including the UK) and the US. We are not expecting tough restrictions (especially not in countries with high vaccine uptake like the UK) but we know that changed consumer behaviour can also affect the economy. Hence, a full normalisation of the economy is most likely further away than what we thought 3-6-9 months ago. The big question is whether there are permanent damages to the economy or not (i.e. will monthly GDP reach its old trend path or not?). That also depends on what happens with the labour force (more on that below).

Labour market

The UK labour market mirrors what we see in other countries like Germany and the US. The labour force is still 1.5% lower than what it was in February 2020 but at the same time there are more than 1.1 million unfilled vacancies (40% more than in February 2020). Payroll employment is now higher than in February 2020 but total employment is still subdued. So is the labour market still recovering from the COVID-19 crisis or is the labour market extremely tight due to permanent damages to the economy? It may be the case that it takes longer for the labour force to rebound. If there are permanent damages to the economy, we should not expect GDP to return back to its old trend path either (lower production potential). With another COVID-19 wave looming (now that it is getting colder), a more significant rebound is likely postponed until next year.

A big unknown for the Bank of England is what the end of the Furlough Scheme means for the labour market. BoE mentioned the closure of the furlough scheme as a key uncertainty for the labour market outlook at the latest meeting in September.

Despite recruitment difficulties are at a high level, wage growth is not growing at an unsustainable pace yet. Wage growth was very high late 2020 and early 2021 but is now running at a more normal pace (when looking at % 3m/3m wage growth). So wage growth does not signal that underlying inflationary pressure is too high right now.

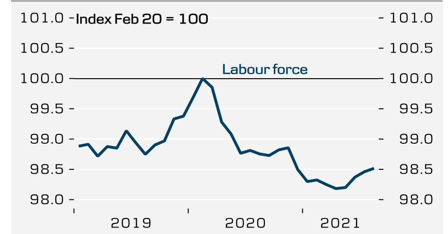
Inflation expectations

Looking at inflation expectations, different data tell different stories. Household inflation expectations (from the Bank of England) have risen across maturities but are not very high in a historical perspective in Q3. Especially long-term inflation expectations still remain relatively well-anchored. 1yr inflation expectations from YouGov/Citi rose to 4.4% in October, however, which is the highest level since the sharp rise in commodity prices in 2008. The Bank of England mentioned the YouGov/City measure explicitly in the minutes from the September meeting.

As expectations are likely driven by a combination of forward-looking and backward-looking elements, expectations may calm down again if energy and food prices start to decline and bottlenecks are solved, just like we saw in the aftermath of the financial crisis. It is, however, important to emphasise that the economic situation now is very different from back then, as the output gap is much smaller. The big question is also whether higher inflation expectations start to spill-over to wage growth demands.

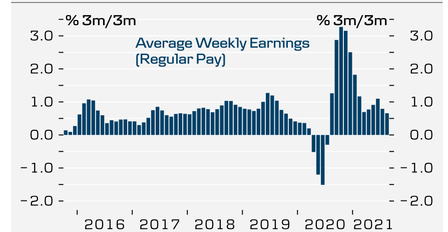
Also market-based 10yr breakeven inflation expectations have risen significantly, now trading above 4% (although it has declined a bit most recently), which is the highest level since the commodity price boom in 2008 – besides that we need to go back before Bank of England became independent in 1997 before finding a higher level.

The labour force is 1.5% lower than before COVID-19



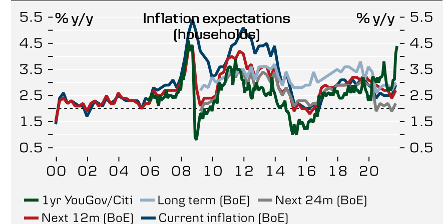
Sources: ONS, Macrobond Financial

Wage growth is not unsustainable high



Sources: ONS, Macrobond Financial

Inflation expectations have risen (but not long-term according to BoE survey)



Sources: YouGov/Citi, Bank of England, Macrobond Financial

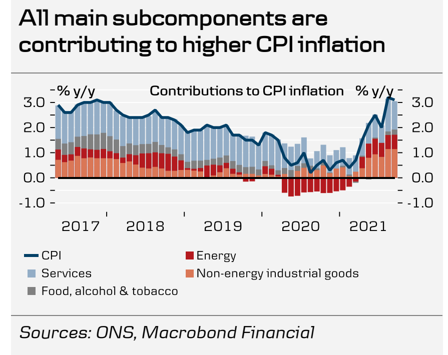
Actual inflation

Actual inflation (both headline and core) has risen significantly in 2021. The increases are broad-based and not just due to energy, as all main subcomponents ("food, alcohol and tobacco", "non-energy industrial goods", "services" and "energy") are contributing to inflation right now. Food prices are likely to increase further, but oil prices will soon start to pull inflation down, unless oil prices start to increase further from here. Non-energy industrial goods inflation has been high despite a stronger GBP, probably related to bottlenecks. "Used car prices" have risen significantly, in line with what we have seen in the US. "Used cars" are contributing 0.3pp to overall inflation (more than 0.4pp taking motorcycles and new cars into account). As in the US, the big question is whether car prices are just the first prices to move or whether they become more broad-based for other types of goods as well. "Furniture" is a suspect, as furniture prices have risen significantly lately. The contribution to headline inflation from "Restaurant & Hotels" and "Clothing & Footwear" are both declining again, however.

The risk of more persistent goods price inflation has increased, especially since we fear new big COVID-19 outbreaks both in Europe (including the UK) and the UK. If this happens, global goods consumption is likely to remain elevated amid supply-side problems.

At the meeting in September, the BoE repeated that it is looking at medium-term inflation *"rather than factors that are likely to be transient"*.

All main subcomponents are contributing to higher CPI inflation



Sources: ONS, Macrobond Financial

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