31 January 2022

Research UK

BoE preview: Another rate hike and passive QT

Key takeaways

- We expect the Bank of England (BoE) will hike the Bank Rate by 25bp to 0.50% on Thursday.
- We expect the BoE will repeat that "some modest tightening of monetary policy […] is likely to be necessary", which we would interpret as a small pushback to current market pricing. A removal would be a hawkish signal, in our view.
- The BoE will announce the beginning of "passive QT" (ceasing of reinvestments) in connection with the meeting if we are right about the hike. BoE is expected to start "active QT" (actively selling bonds to markets) when the Bank Rate reaches 1.00%.
- We still expect two further hikes this year (May and November). Hence, the BoE is likely to announce "active QT" in connection with the November meeting. Risks are skewed towards more hikes than we have pencilled in.
- Markets are pricing in nearly five rate hikes. Hence, we also see a higher probability of a dovish surprise than the other way around.
- FX: We still think 0.83 is the bottom for EUR/GBP and seeing a case for a slight move higher to 0.84 in 12M in case the BoE is not as hawkish as currently priced.

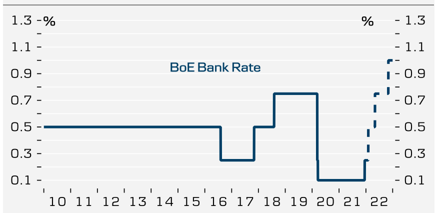
BoE is set to repeat that "some modest tightening" is needed

We expect the Bank of England to hike for the second time since the pandemic on Thursday, the first back-to-back rate hike since 2004. We expect the BoE to raise the Bank Rate to 0.50% from 0.25%. BoE Governor Andrew Bailey sounded concerned when he spoke a week ago emphasising that the tight labour market may imply upward pressure on wages and commodity prices remain high. It is important to keep in mind that the BoE, unlike e.g. the ECB, did not struggle with too low inflation ahead of the pandemic. Inflation expectations are also quite high, although the 1-year expectations in the YouGov/Citi survey declined in the most recent report.

At the December meeting, the BoE called the omicron variant a new risk to public health and hence also the economy. The situation is completely different now. We know the variant is milder and the UK government is removing restrictions. Hence, the overall impact of the economy was likely modest and short-lived supporting the case for monetary policy tightening.

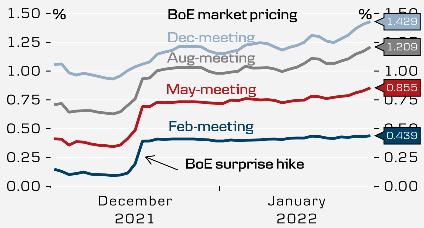
We expect the BoE will repeat that *"some modest tightening of monetary policy […] is likely to be necessary"*. We would interpret this is a small pushback to current market pricing. A removal would be a hawkish signal, in our view.

We expect a total of three rate hikes this year (risks skewed towards more)



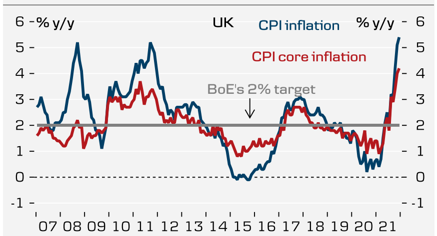
Note: Past performance is not a reliable indicator of current or future results.
Sources: Bank of England, Macrobond Financial, Danske Bank forecasts

Markets are pricing in around five rate hikes this year



Note: Past performance is not a reliable indicator of current or future results.
Sources. Bloomberg, Macrobond Financial

CPI inflation significantly above the 2% target (and no significant undershooting like the ECB before the pandemic)



Sources: ONS, Macrobond Financial

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At the August 2021 meeting, the BoE said it *"intends to begin to reduce the stock of purchased assets when Bank Rate has reached 0.5%"*, so we will likely get more details on QT if we are right about the rate hike. The BoE also said that QT *"should initially occur through ceasing the reinvestment of maturing assets"* (passive QT) but is open to actively sell bonds when the Bank Rate reaches 1% (active QT). For more details see page 13 in the *Monetary Policy Report August 2021*.

The UK yield curve (see e.g. the 10s2s spread) is inverted and hence it may very well be the case that the Bank of England is more aggressive on QT than other central banks in an attempt to increase the longer-end of the UK yield curve, although the evidence for this relationship is not very strong.

Our base case is three rate hikes in 2022 (February, May and November) but markets are pricing in around 125bp this year, i.e. five rate hikes. We also see risks skewed towards more rate hikes than the three we have pencilled in right now, but we still see five as being to the aggressive side, also given the headwinds the UK economy may face over the course of the year, such as tighter fiscal policy.

FX: Bottom in EUR/GBP

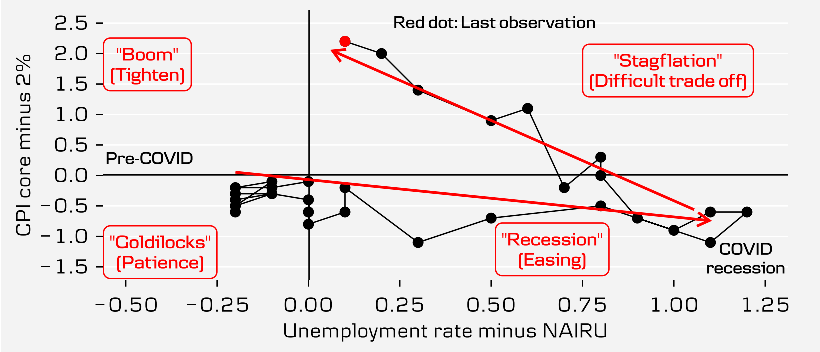
We are still of the view that 0.83 was the bottom in EUR/GBP. Markets are pricing in a total of nearly 125bp rate hikes this year, which is more than our base case (75bp), although we recognise that risks are skewed towards more rate hikes. It may be that we are wrong and markets are right, but unless inflation surprises to the upside over the course of the year, we think it is difficult for markets to price in more rate hikes than the current five. That also means that GBP will see less support from relative rates going forward. If anything, relative rates may become a drag if markets start to price in more aggressive actions from the ECB/less aggressive actions from the BoE.

That said, there are definitely also factors supporting GBP. We are in a positive USD environment (tighter monetary and financial conditions, slower global growth etc.), which usually benefits GBP vs. EUR, NOK and SEK.

Therefore, with two factors pushing in opposite direction, we believe EUR/GBP will trade around 0.84 in 12M.

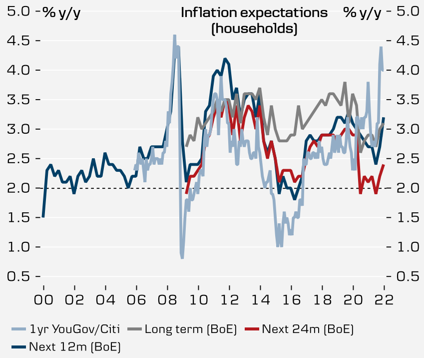
Near-term, we would like to emphasise that GBP remains fragile during risk sell-off, also making EUR/GBP more volatile in an environment as the current one. As markets are pricing in a rate hike from the Bank of England next week, the hike in itself should not move markets. The question is whether BoE pushes against market expectations or not.

The UK economy is moving into "boom" territory



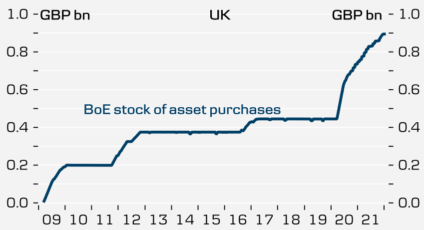
Sources: ONS, Macrobond Financial, Danske Bank

Higher inflation expectations



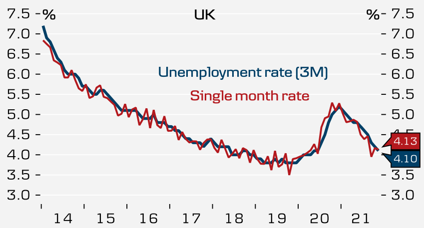
Sources: Bank of England, YouGov/Citi, Macrobond Financial

Time to start "passive QT" in case of a rate hike



Sources: Bank of England, Macrobond Financial

The unemployment rate is nearly back to pre-covid levels



Sources: ONS, Macrobond Financial

Our Bank of England call summarised

We expect the Bank of England to hike the Bank Rate to 0.50% at its upcoming meeting on Thursday. We expect two additional hikes this year (May and November) but risks are skewed towards more rate hikes. Markets are pricing in nearly five rate hikes this year.

We expect the BoE to announce “passive QT” (ceasing reinvestments of maturing bonds) in connection with the upcoming meeting. The BoE has previously stated QT would start when the Bank Rate reaches 0.50%. We expect “active QT” (selling bonds to markets) when the Bank Rate reaches 1%. Our base case right now is that happens in November, but since we believe risks are skewed towards more rate hikes, risk is also skewed towards an earlier start for “active QT”.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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