

A February Bank of England rate hike? It's 50:50

The chances of a Bank of England rate hike in February are rising. Inflation is set to peak higher than previously expected, while Omicron's damage is likely to be lower and less long-lasting than past waves. We think the odds are about 50:50 for a February move, though we narrowly suspect policymakers will wait until May to fully assess the hit from Covid-19



Source: Shutterstock

A February rate rise is growing more likely

Will the Bank of England hike rates again at the start of February? Markets think the answer is yes. We narrowly reckon the committee will wait until May, though February's meeting is looking much more 50:50 than it did just a few weeks ago.

Partly, that's because it looks like Omicron's economic damage will be neither huge nor long-lasting.

True, staff shortages are a pressing issue for most firms, while the latest card spending data shows

social spending fell off a cliff in late December. There's a decent case for waiting for more data, as the committee did last November, and that's why we're still leaning towards a rate hike in May. A negative December and January GDP reading look likely.

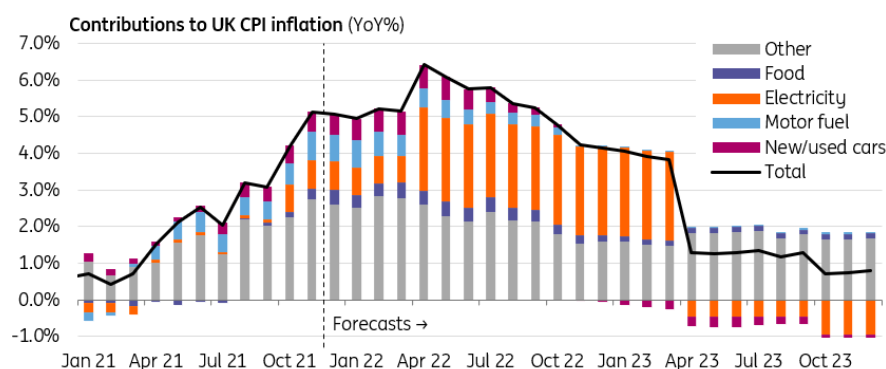
But equally last month's rate hike decision – taken as Omicron's wave was well underway in London – shows that the committee, like the Fed, is placing decreasing emphasis on Covid-19. In the absence of tighter restrictions, much could depend on whether cases and hospitalisations have peaked nationally much before the 3 February meeting.

Inflation is set to peak above 6%

Perhaps more importantly, inflation is clearly going to peak much higher than the Bank (and ourselves) expected only a few months ago. We're forecasting a high of roughly 6.5% in April, and expect headline CPI to end 2022 close to 4%.

Unsurprisingly, this is heavily linked to the spike in gas and electricity prices. In fact for most of 2022, electricity alone is likely to be contributing over two percentage points to those headline inflation rates.

Contributions to UK headline inflation rates



Source: Macrobond, ING forecasts

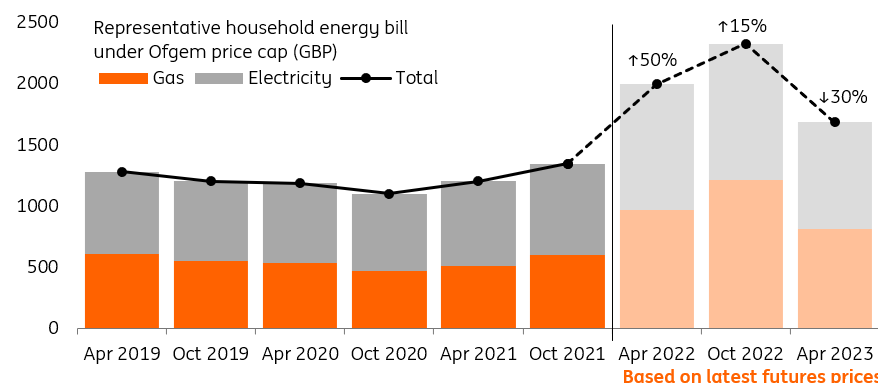
So far, households have been insulated from the bulk of the recent cost pressure by the semi-annual price cap system. However, the next update in April – which will be calculated using average futures prices between last August and the end of this month – looks set to deliver a 50% increase in household energy prices. At their peak before Christmas, gas prices were pointing to an increase in excess of 60%.

What's more, if futures prices were to stay where they are today (a big 'if', admittedly), our estimates suggest we could see something like another 15% rise this October.

The Bank of England's Governor Andrew Bailey, along with other hawkish committee members, have previously sounded the alarm about higher headline inflation and the possible feed-through to expectations and future inflation rates. There has already been an uptick in some measures of consumer inflation expectations, though in practice these tend to track current CPI rates. We're a little less convinced that higher UK inflation rates in isolation will drive the wage/price spiral that hawkish BoE members are concerned about.

Nevertheless, with the jobs market also looking fairly tight, the Bank is set to hike rates further. And a higher inflation peak means policymakers may be more tempted to move again in February.

Households set to see a sharp rise in energy prices this year



Source: Ofgem, ING

Forecasts are based on Ofgem's calculation model, and our estimates of the direct fuel component of household energy bills. For simplicity, we've assumed other non-fuel costs remain unchanged

Don't expect a rapid string of rate rises this year

But whether it's enough to convince policymakers to hike Bank rate as far as 1% by August, as markets are now pricing, seems much less likely.

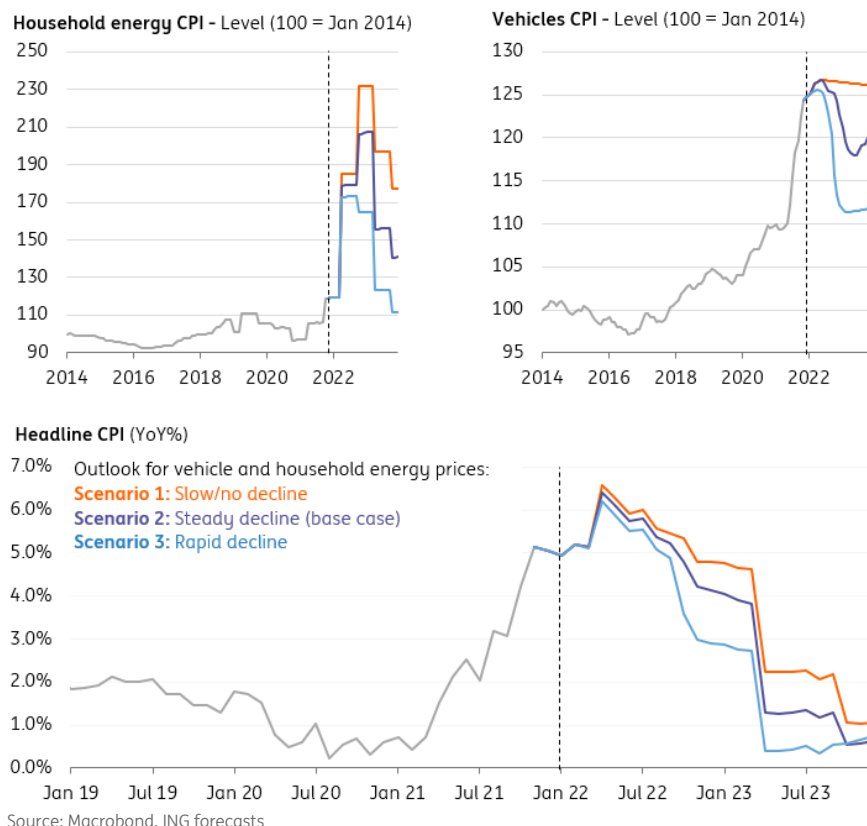
The flip side of higher electricity prices is a sharp cost of living crunch. Wage growth is hard to pin down right now owing to various data distortions. Vacancies are high, but wage pressures appear less powerful than they are in the US. It's highly unlikely that pay will keep pace with price gains for most (if not all) of this year. That will cap consumer spending growth in coming quarters.

We also think headline inflation will fall below target in 2023, pretty much whatever happens to electricity prices next year. Admittedly [energy costs could stay fairly volatile](#), which as we've written before, is partly linked to the UK's reliance on wind, solar and gas for power (as well as very low gas storage capacity). Our commodities team also [expects gas prices to stay supported](#) for the time being.

Even so, a fall in the household energy cap seems likely by April 2023, and by then we may have also seen a bit of mean-reversion in used car prices. These have risen by 30% in the past six months, but should fall back as supply chains improve through this year – though how quickly and steeply prices will correct, is much harder to pin down.

We've put together three illustrative scenarios for electricity and car prices in the chart below, and each show that inflation will most likely be below target by the latter parts of 2023.

UK inflation scenarios based on different paths for electricity/car prices



Scenarios based on rough scenarios for electricity and car prices. All other price categories are kept fixed (using our base case)

Does this matter for the Bank of England? You could argue not, given that neither energy nor car prices are things it can control. But it is another argument against worrying too much about higher UK inflation rates this year. And that suggests we're more likely to only get two rate rises spread across 2022, not least because the Bank also plans to begin shrinking the size of its balance sheet in tandem.

Ultimately, a lot will hinge on wages - and where the data takes us later this year once the pandemic's distortions begin to fade.

Author

James Smith

Developed Markets Economist

james.smith@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group*

(being for this purpose ING Group N.V. and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.