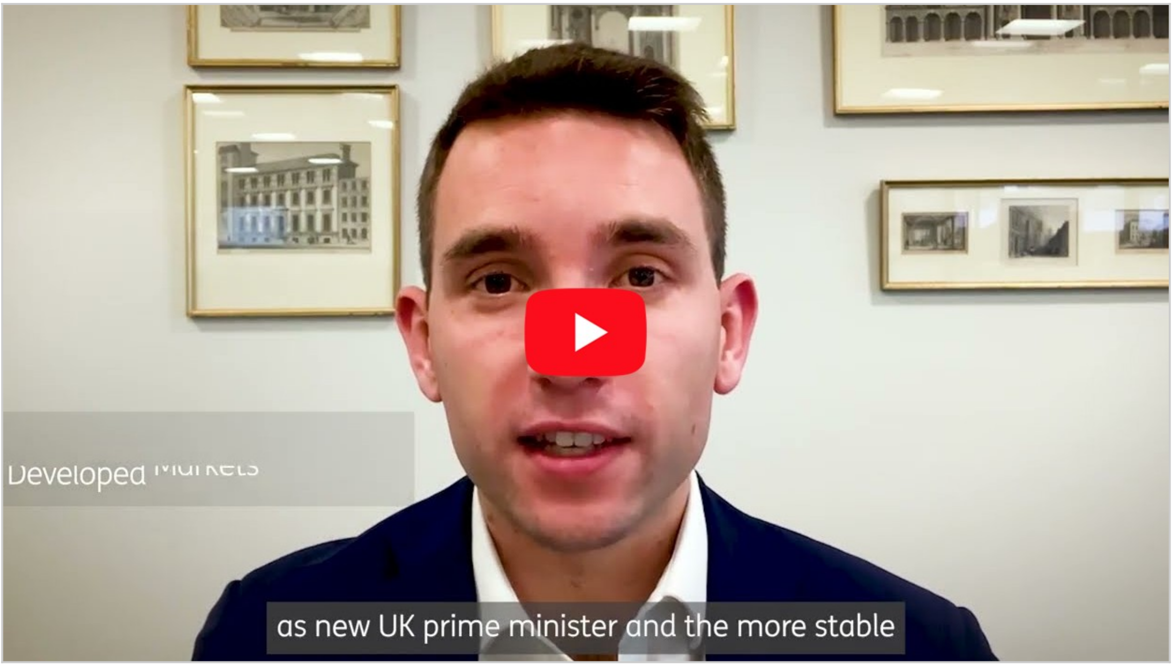
Bank of England: Four scenarios for the November meeting

Thursday's Bank of England meeting has become a close call, and we now narrowly favour a 50bp rate hike. That would be a surprise for markets, sending gilt yields lower and driving GBP/USD back towards 1.14



Shift in UK leadership reduces pressure on the Bank of England

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Four scenarios for the Bank of England meeting

	Bank of England actions/comments			Market impact
	Decision	Outlook	Future tightening	(GBP/USD: 1.1560 10Y Gilt: 3.50%)
1	50bp rate hike 8-1 vote in favour	Cumulative hit to GDP of more than 5% if rates to rise as far as markets expect & fiscal policy turns more contractionary	Signals greater worry about growth than inflation. Signals clearly that markets are overestimating tightening	GBP/USD: **1.1350** 10Y yield: **3.40%**
2 (ING base case)	50bp rate hike 6-3 vote in favour	Hefty growth downgrade on higher market rates. Inflation less than 1% in 2025	Signals Bank could still act 'forcefully' if required, but offers pushback against current market rate hike expectations	GBP/USD: **1.1400** 10Y yield: **3.45%**
3	75bp rate hike 6-3 vote in favour	Big growth and inflation downgrades but cites inflationary impact of fiscal policy as warranting one-off bigger move	Signals Bank could act 'forcefully' again but hints that 75bp rate hike is unlikely to be repeated	GBP/USD: **1.1600** 10Y yield: **3.55%**
4	100bp rate hike Committee divided	Points to tight jobs market, energy price guarantee and concerns about sterling. Only expects modest recession	Committee heavily divided on need to tighten aggressively but bank signals further forceful action is likely	GBP/USD: **1.1750** 10Y yield: **3.65%**

Source: ING

Forecasts based on spot rates as of 31 October. GBP/USD at 1.1560 and 10Y yields at 3.50

We narrowly expect a 50bp rate hike this week

Judging by recent comments, it's increasingly clear that the Bank of England is uncomfortable with the amount of tightening priced into financial markets over coming months. Investors expect Bank Rate to peak just shy of 5% next year (from 2.25% currently).

That leaves two potential options for Thursday's meeting. Firstly, the BoE could validate market expectations and hike by 75bp for the first time in this tightening cycle, but signal clearly that it's likely to be a one-off. That's the consensus view among economists. Alternatively, the Bank could hike by 50bp, as it did in September, but continue to signal that it is prepared to hike forcefully if required. We now narrowly think this is the more likely outcome, though in either scenario the committee is likely to be highly divided. Read our preview for more detail on our thinking.

The central message though, be it via the vote split, the new forecasts or the language in the policy statement, is that markets are overestimating the scope for future rate hikes. Our own view is that Bank Rate is unlikely to go above 4%. Regardless of whether we get a 50bp or 75bp hike this week, we think we'll get a 50bp hike in December and another 25 (or perhaps 50bp) move in February before the Bank pauses.

Six reasons why the BoE could hike by 50bp this week

1. **The BoE has signalled markets are overestimating future rate hikes** Hiking by 50bp would send a clear message to investors
2. **U-turns mean the fiscal boost is similar to what was expected in September.** Energy price cap has since been made less generous
3. **Economic data doesn't provide a clear justification for 75bp hike** Jobs market remains tight, but CPI was as expected & growth weaker
4. **Trade-weighted pound is stronger than at September's meeting** That should dampen concerns about a weaker GBP at the margin
5. **A 75bp hike risks setting a precedent** – markets would view it as the default. Could blur message that too much tightening is priced
6. **The committee is divided on the need for more aggressive hikes** Another three-way-vote-split is possible this Thursday

Source: ING

Gilts: re-steepening on a 50bp hike

For gilts, and by extension sterling-denominated rates, all of the good fiscal news is already in the price. Granted, larger windfall taxes could help close the 'political risk premium' that opened against euro and dollar rates in September. This is likely to be balanced by the reduced sense of urgency that the government potentially feels in implementing unpopular fiscal tightening, now that markets have calmed down somewhat. In short, we think fiscal risks are now reduced, and roughly balanced. The focus is instead squarely on the BoE meeting, especially since the 31 October budget has been delayed.

A 50bp call by the BoE would be a powerful signal that it doesn't intend to bow to market pressure for aggressive tightening. There is a risk to this strategy, however. Markets have consistently priced a more hawkish path than the BoE has signalled ever since the start of this tightening cycle last year, so the BoE faces an uphill battle to convince them that smaller increments are the correct approach.

A 50bp call by the BoE would be a powerful signal that it doesn't intend to bow to market pressure

Despite this risk, we expect a bullish reaction in gilts. The move would be a hint of a less hawkish BoE reaction function but this is likely to be balanced by greater term and inflation premia baked into longer-dated yields. The gilt rally into this meeting already incorporates decent dovish expectations so a 50bp hike would allow gilts to consolidate their gains below 3.5%, though they will struggle to make more headway towards lower yields. A more noticeable reaction would be a re-steepening of the curve on the lower BoE path at the short end and greater inflation premia at the long end.

GBP: A 50bp rate hike would weigh on the currency

Sterling continues to trade with high volatility in the FX options market, which prices a 150 pip GBP/USD range for Thursday. As per the scenario analysis table, we believe the disappointment of a 50bp rate hike would send GBP/USD back down to the 1.1400 region this week.

Providing some backing to this view is the external environment, where we think the balance of risks favour a stronger dollar. Plus, tighter liquidity conditions around the world will typically weigh on currencies like sterling, with large external funding needs.

A GBP/USD rally from here requires a soft dollar environment, the Sunak government credibly filling the £35bn funding gap at the 17 November Autumn statement, and the BoE pushing ahead with a more aggressive tightening cycle. We think the combination of all three is unlikely.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com