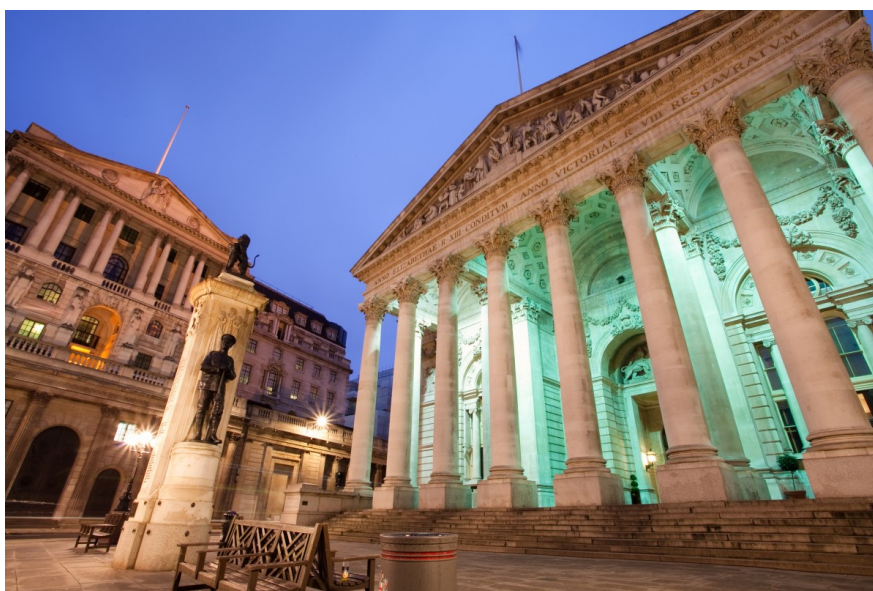


## Bank of England: Hawkish hints unlikely as growth headwinds build

The ongoing acceleration in UK inflation, coupled with tighter fiscal policy, is set to weigh on growth over winter. Without more widespread signs of wage growth, the first Bank of England rate hike is likely to come later than markets are currently expecting. We're pencilling in a 15bp move for November 2022



Bank Of England, London

Source: Shutterstock

The Bank of England will release its latest decision on Thursday at 12:00 UK time. We expect a unanimous vote to keep rates unchanged at 0.1% and an 8-1 vote to keep the quantitative easing programme on track to finish in December. No new forecasts will be provided this time

### Markets are pricing a rate hike in around six months time

Will the Bank of England hike interest rates in February 2022? That's more-or-less when markets

are currently expecting the first 15bp move, with a further 25bp rate hike priced for the second half of next year, too. But if investors are looking for the BoE to endorse this outlook when it releases its latest policy decision this Thursday, they are likely to be disappointed.

Indeed, we think markets are jumping the gun, and instead we expect the first rate rise to come in the second half of 2022, probably in November.

That's mainly because the recent rise in inflation is not necessarily as hawkish as it might seem. True, headline CPI is expected to rise to 4% by the end of this year, higher than many (including us) had expected only a few months ago. The recent upside surprise in August's inflation numbers were a key factor in bringing market rate hike expectations forward.

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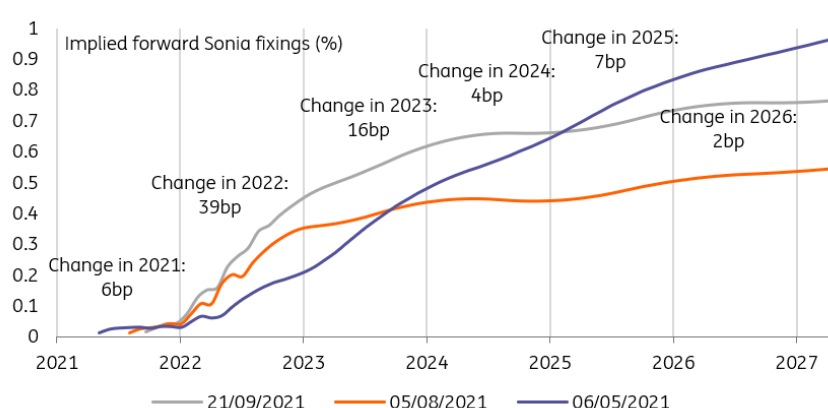
### *We expect the first rate rise to come in the second half of 2022*

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But for the Bank to react, there needs to be a clear sign that the underlying driver is 'domestically generated' – that is to say, within policymakers' control. And here, the signs suggest this isn't currently a huge issue for the Bank. While there have been some signs of rising prices as services reopened, recent inflation spikes have been disproportionately linked to a narrow set of items – including, like the US, used car prices.

That's not to say the forthcoming rise in inflation is completely 'transitory'. October's eye-watering 12% rise in the household energy cap may well be followed by another double-digit rise at the next review in April 2022, given what's going on with gas prices. And with supply chain disruptions, if anything getting worse, the inflation spike associated with various goods is likely to continue into 2022. Inflation will inevitably fall back to target, though perhaps not until the latter stages of next year.

## The GBP yield curve implies hikes will be front-loaded to 2022



Source: Refinitiv, ING

## Unemployment justifies some BoE caution as furlough ends

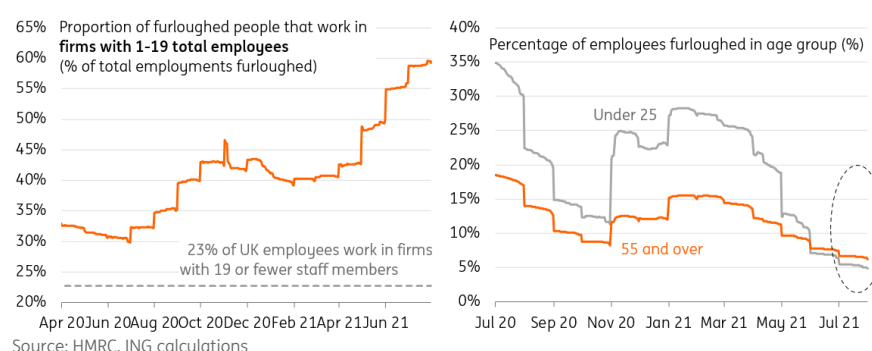
However this spike in prices is unlikely to be matched by a prolonged rise in wage growth, despite recent headlines about staff shortages. While there's little doubt firms are having to pay up to hire

lorry drivers, chefs and food production workers, these stories are coinciding with the end of the furlough scheme this month.

And as of the end of July, there was still a surprisingly high number of people receiving wage support. Even in construction, where activity is essentially at pre-virus levels, 9% of workers are still furloughed. Importantly, 60% of those on the scheme are in firms with fewer than 20 employees, even though these companies only make up around a quarter of total employment. Older workers are also now more likely to be furloughed than younger ones. To us, all of this is indicative of a rise in unemployment over coming weeks, albeit a relatively minor one compared to predictions made earlier this year. It could also translate into a rise in inactivity if workers are pushed into early retirement or are unable to work their ideal number of hours.

In short, the jury's out on wages - certainly the story is more complex than recent staff shortage headlines suggest. We tend to think we aren't about to enter a period of pay growth that would trigger a bout of above-target inflation.

## Older workers and those in smaller firms more likely to be still furloughed



## Tighter fiscal policy will contribute to a slower recovery from here on

That's particularly true if you consider recent fiscal announcements, which suggest government policy is set to become noticeably less stimulative. A £20/week uplift in Universal Credit (welfare benefits) will end in a couple of weeks, while National Insurance (paid by employees and firms) will be hiked next April.

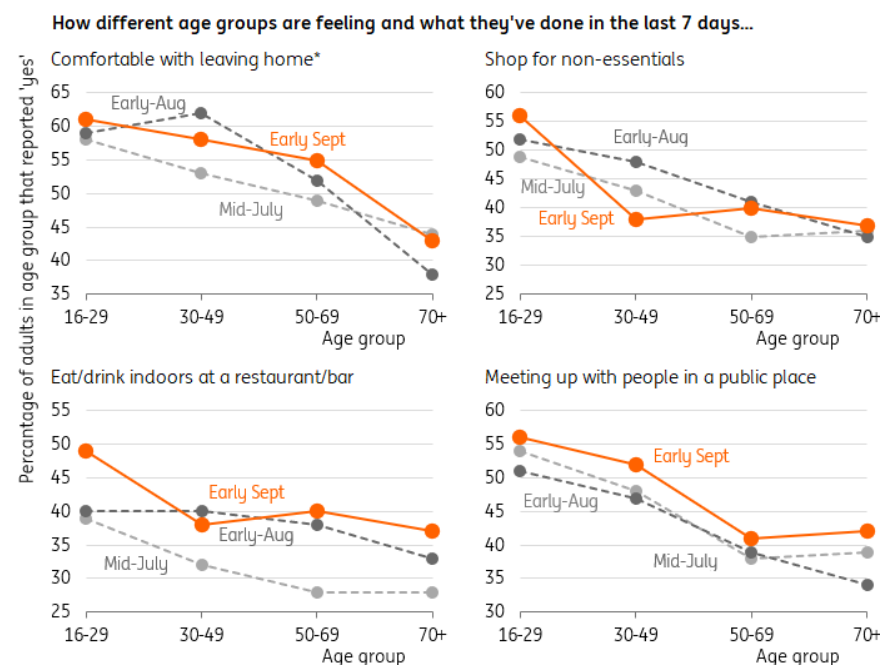
The effect is likely to be something of a cost of living spike this winter, particularly for lower earners who will be disproportionately affected by the UC cut, but also sharply higher energy/goods bills given these items make up a larger share of their spending. Remember too, that the rise in savings through the pandemic disproportionately benefited higher earners.

This is one of the reasons we expect the pace of the recovery to slow considerably relative to the buoyant second quarter, and indeed much has been made of the lower-than-expected GDP figure for July.

This rendered the BoE's 3% 3Q growth forecast too optimistic, though something closer to 1-1.5% has seemed likely for a while. In fact, the impact of the Delta Covid-19 variant has been less

dramatic than we'd feared. Since July, activity appears to have increased slightly, and ONS survey data suggests confidence in leaving home for non-essential activities is still fairly solid – though clearly the risk is that this changes as we head into winter.

## Consumers still fairly confident about leaving home



Source: ONS Coronavirus and the social impacts on Great Britain

Survey dates: Early Sept (5 Sept), Early August (8 August), Mid-July (18 July) \*

\*'Very comfortable' or 'comfortable'

## Don't bank of a hawkish tilt from the BoE this week

So what kind of message should we expect this Thursday? There have been calls for the Bank to tighten policy earlier given the strength of the recovery so far this year, and to some extent this is reasonable. Indeed, it may well be the case that a narrow majority of MPC members now think the conditions for tightening to begin have been met.

But remember that unlike the Federal Reserve, the BoE is already tapering its QE programme, and the active expansion of the balance sheet will end later this year. We're likely to see MPC member Michael Saunders vote to bring this forward, though as in August, this probably doesn't have much wider support.

However, a rate hike at the start of 2022 as markets are pricing relies on a lot of things falling into place, not least signs of widespread increases in wage growth.

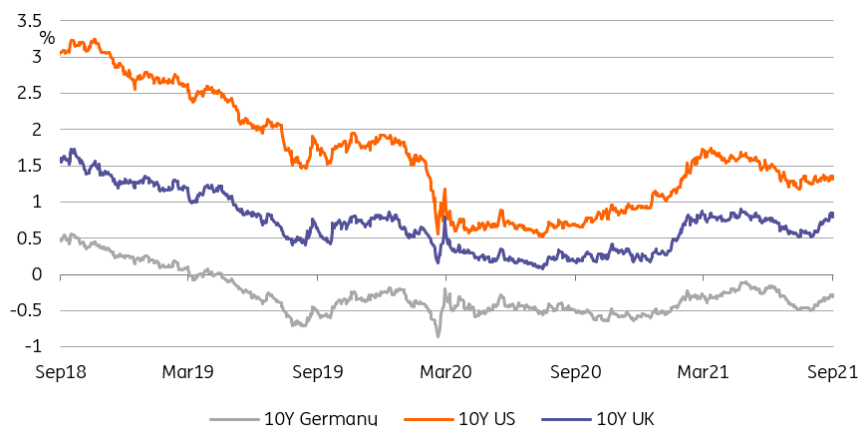
With markets already pricing in a rate hike in the not-so-distant future, there's little incentive for the Bank to unnecessarily tie its hands by endorsing a particular timeline this week. We therefore expect the Bank to simply reiterate its plan for 'modest tightening' over the next few years.

## GBP rates: No re-steepening just yet

Every bond market reflects, first and foremost, its domestic developments. However, the longer the duration of the interest rate product considered, the greater the correlation with markets

denominated in other currencies. Gilts are no exception, correlating at times better with US Treasuries, and at times with German Bunds. Price action of late has been a reflection of this twin influence: the outright rates direction has been more strongly linked to the inflation-related sell-off in EUR rates, while curve developments bear a striking resemblance to that of USD markets.

## UK gilts sold off alongside German Bunds, and unlike US Treasuries

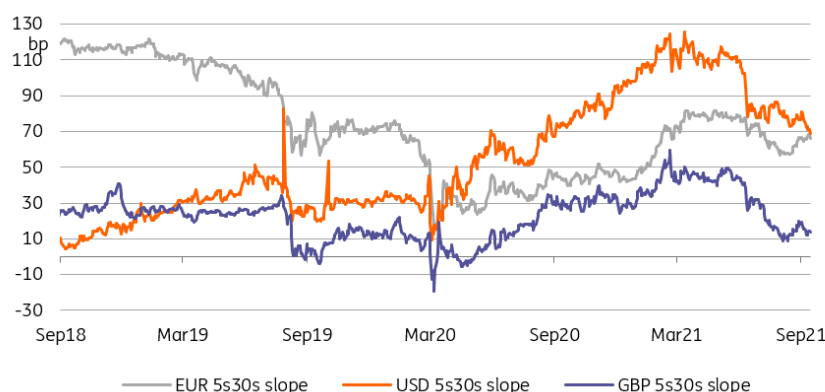


Source: Refinitiv, ING

### *The curve isn't breathing optimism about the future*

Looking under the hood, the GBP rates sell off has been more driven by the rebound in inflation and inflation expectations rather than sheer optimism about the future. Interestingly, an acceleration of price developments, and expectation thereof, is increasingly reflected in shorter-dated maturities, with the curve bringing forward the date of the first BoE hike- hawkish warnings saw to that. The curve isn't breathing optimism about the future however, so its reflex has been to flatten to reflect that an earlier start to the hiking cycle also means an earlier end.

## ...but the GBP curve shows the same late cycle flattening as in USD



Source: Refinitiv, ING

*Price action is consistent with the way the GBP 5s30s segment flattened throughout the 2017-18 hiking cycle*

This may seem contradictory as the BoE's own QE programme will come to a hard stop in December, and balance sheet reduction should start once the Bank Rate reaches 0.5% (ie, by 2H 2023 if the OIS curve is anything to go by). This has failed to trigger a rise in term premia for long dated rates, as one might have expected, but price action is consistent with the way the GBP 5s30s segment flattened throughout the 2017-18 hiking cycle. The difference here is that a hike is realistically one year away at least, and the curve is flatter already. This opens the way to a tactical re-steepening if the BoE fails to step up hawkish warnings but we doubt this would lead to a broader steepening trend.

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