Bank of England set for several rate cuts despite current caution

Sticky services inflation and a more hawkish tone from the Bank of England means investors are starting to price a less aggressive easing cycle in the UK relative to the US. We doubt that divergence will last long

Andrew Bailey, governor of the Bank of England

Investors are starting to consider BoE divergence from the Fed

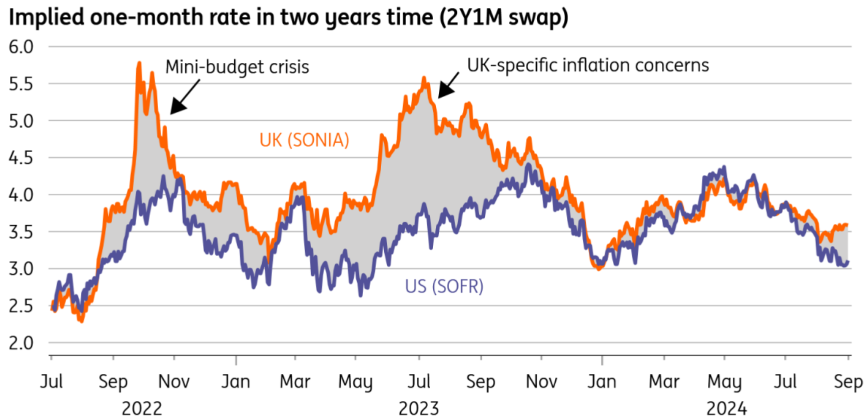
Not for the first time in recent years, investors are thinking the Bank of England will take a more hawkish path than the Federal Reserve. Markets expect UK rates to end up 50 basis points above the US in two years' time. They also think the BoE will opt for fewer rate cuts in total this year.

In part, this is because the signals emerging from the Bank of England and the Federal Reserve have been quite different in recent weeks. Where the Fed's Jerome Powell has emphatically endorsed a September rate cut with little hint of gradualism, BoE governor Andrew Bailey is toeing a much more cautious line.

The idea of Bank of England divergence is also not unprecedented. The Fed completed an entire hiking and cutting cycle between 2016 and 2019, where the BoE kept rates largely unchanged. It was a similar story in the early 2000s.

This time, investors are looking at elevated levels of UK services inflation and wage growth, and are concluding that this will limit the scope of rate cuts in Britain. Officials are also questioning whether it'll take more pain for the UK jobs market to lower inflation, or worse, if price and wage setting behaviour has permanently changed, making it much harder to get inflation consistently back to target.

Markets think UK rates will fall less far than the US



Source: Macrobond

We expect BoE rate cuts to accelerate in the fourth quarter

We suspect both concerns are overblown. The fact is, the jobs market has cooled significantly over the past couple of years. True, much of this is down to higher worker supply than a rise in layoffs, but that still implies downward pressure on wage growth.

Meanwhile, the BoE's survey of chief financial officers suggests firms are raising wages less aggressively than they were six to 12 months ago. There are signs that firms are raising prices less regularly too, a hint that pricing behaviour hasn't permanently shifted in the way that some of the BoE hawks have feared.

The Bank is unlikely to cut rates for a second time at its September meeting, but from November we suspect the pace of cuts will accelerate. We therefore don't think the Bank's cutting cycle will look materially different to that of the Fed. We reckon that Bank Rate will fall to 3.25% by next summer, which is further than markets currently expect.

That's despite the UK economy delivering a remarkable performance through the first half of this year. GDP has grown by 1.5% since last December, which has eclipsed most of its European neighbours. Unsurprisingly some of this can be traced back to the recent improvement in real wage growth, though other recent trends are harder to explain.

Like the Bank of England, we suspect the economy will return to more "normal" growth rates of 0.3-0.4% through the second half of this year. As a result, the recent strength is unlikely to make too much difference to the Bank's strategy on rate cuts.

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