Bank of England set to resist temptation of a 50 basis-point rate hike

Expect another 25 basis-point hike from the Bank of England this Thursday as policymakers continue to balance the risk of persistently high inflation against an uncertain growth backdrop. Markets, which are now pricing a terminal rate close to 3.5% next year, seem to be considerably overestimating the pace of future tightening

Markets are pricing more and more from the Bank of England

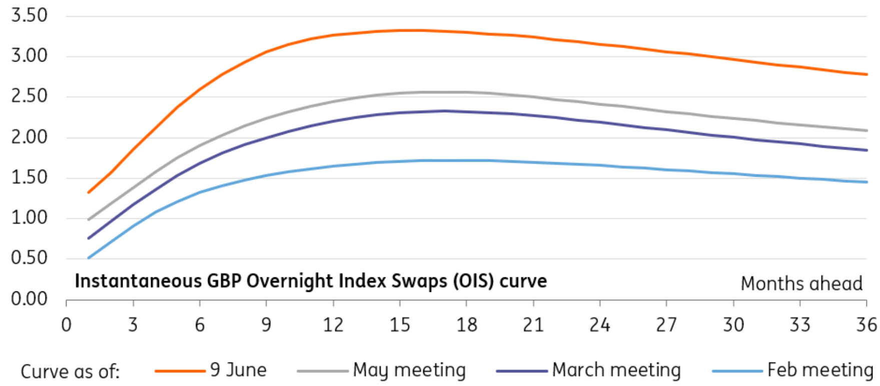
That the Bank of England will hike rates again this week, there seems no question. And more importantly, markets expect plenty more over coming months. The combination of Friday's US inflation surprise and a hawkish European Central Bank mean investors now expect 75 basis points worth of rate hikes to be delivered across the next two meetings, and see Bank rate hitting almost 3.5% by this time next year.

This, despite the Bank signalling at its last meeting in May that market expectations were overdone. Official forecasts, which were based on the market-implied path of interest rates at the time, showed inflation well below target in 2024. The additional tightening that has since been priced into financial markets presumably would result in an even lower inflation forecast if those numbers were run again now.

That makes it hard to see the committee as a whole coming down in favour of a 50bp hike this week. Such a move, which would still be a surprise for markets, risks fuelling the rise in tightening expectations yet further, something we aren't convinced policymakers are keen on doing.

We therefore expect another 25bp hike, which would be the fourth consecutive move of that magnitude. However we should still expect a split vote. Three officials voted for a 50bp hike at the May meeting, and it's possible we see a fourth – perhaps Dave Ramsden – join their ranks. The hawks are clearly nervous about the tight jobs market and the risk of sustained, above-target wage growth. The root cause of worker shortages (lower migration and higher long-term sickness) are unlikely to be resolved quickly.

Markets have ramped up their BoE tightening expectations



Source: Macrobond (Bank of England data), ING

Cracks are forming in the Bank's resolve on tightening

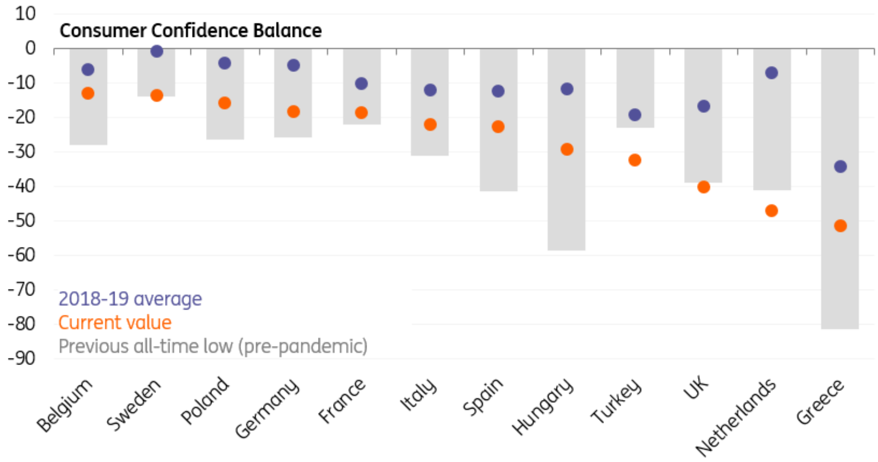
But the doves are also slowly becoming more vocal. May's meeting minutes not only revealed that some members were more nervous about accelerating the pace of hikes, but actually wanted to scrap the Bank's forward guidance that additional, future rate hikes would be needed.

The wild card scenario for Thursday is therefore that we get a three-way vote split – that is some officials opting for no change, some for 50bp, and an overall majority in favour of 25bp. This would be unusual, and a three-way vote has only happened six times since 1997 and not since the financial crisis.

In practice, the recent announcement of extra government support for consumers will probably convince the doves to continue backing rate rises this week. Another 6-3 vote in favour of a 25bp hike therefore seems the most likely outcome.

But these cracks in the MPC's resolve on tightening will probably continue to form. And that makes it hard to see investors' tightening expectations being realised.

UK consumer confidence is at an all-time low



Source: Macrobond, ING

We expect three more rate hikes, including this week's

The situation in the jobs market, alongside the £15bn extra government stimulus is probably enough to convince the committee to hike in June, August and September. That stimulus, which is targeted at those most affected by higher fuel bills, will lift GDP by perhaps a half a percentage point, with most of the impact in the second half of the year. That will help mitigate against the risk of a technical recession.

But consumer confidence remains at an all-time low, while the latest PMIs pointed to a sharp slowdown in business activity. Economic growth looks set to come in comfortably negative for the second quarter, and below the Bank of England's forecasts. While the UK bears some similarity to the US inflation story, the growth backdrop looks much more similar to that of the eurozone.

After three more hikes, which would take Bank rate to a level that more closely resembles a neutral setting, we expect the Bank of England to press pause on its hiking cycle.

Author

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