Bank of England to downshift to a 50bp hike

Despite higher-than-expected inflation in October, we expect the Bank of England to revert to a 50bp hike at its December meeting. Gilts are back to pre-budget crisis levels. They should outperform Bunds but not Treasuries. Sterling has recovered strongly but will struggle to make further gains in a challenging investment environment

We expect the Bank of England to revert to a 50bp hike at its December meeting

The 75bp November hike was a one-off, but we may see one more hike in February

When the Bank of England (BoE) hiked by 75 basis points (bp) for the first time back in November, it seemed obvious that it would be a one-off move. The clear signal was that markets were – at the time – overestimating the scope for future tightening. The forecasts released back then suggested that keeping rates at 3% would see inflation overshoot (just) in two years, while raising them to 5% would see an undershoot. In other words, we should expect something somewhere in the middle, and that's why we think Bank Rate is likely to peak at 4% early next year.

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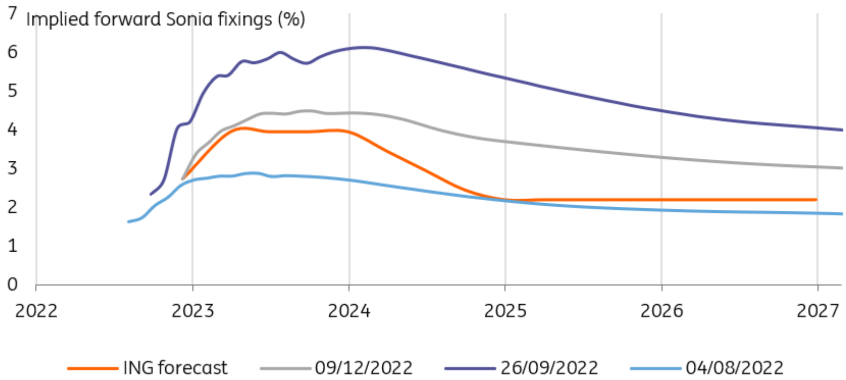
We shouldn't totally rule out a repeat 75bp move on Thursday, and the data flow has leaned slightly hawkish since November's meeting. The Bank's favoured measure of core services inflation, by our estimates, came in slightly higher than it expected – and jobs market data has also shown few signs of cooling just yet. Inflation and jobs data due out in the days prior to the meeting will be important.

Then again, Chancellor Jeremy Hunt probably did just about enough in his Autumn Statement to calm BoE concerns that fiscal policy is working at cross purposes with monetary. While much of the fiscal pain was delayed to future years, the government did still scale back energy support for households next year. With sterling also materially stronger, and markets geared up for a 50bp hike, there's little need to rock the boat with a more aggressive move.

Assuming we're right, we then expect another 50bp move in February which will likely mark the end of the tightening cycle. But with wage pressures unlikely to fully abate even if the jobs markets begin to weaken, we think the BoE will be less swift to cut rates than the US Federal Reserve. For now, we're pencilling in that the first rate cut will come in the first few months of 2024.

The swap curve has dramatically pared down its BoE hike expectations



Source: Refinitiv, ING

The BoE hikes, but the swap curve is focused on cuts

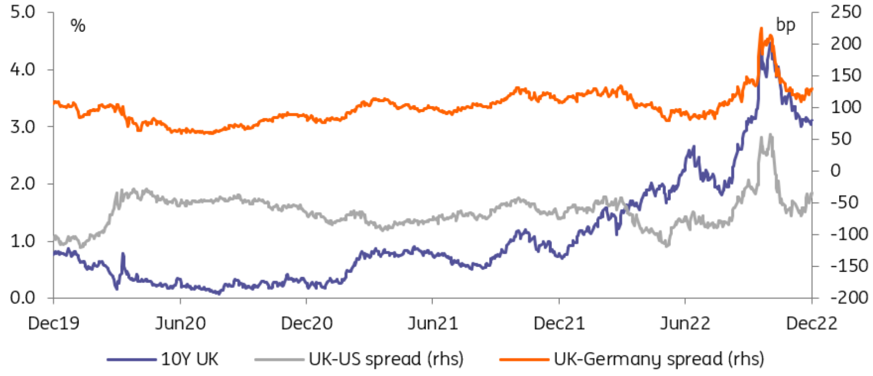
The gilt market has practically shaken off all of the additional risk premium relative to other 'core' government bond markets that appeared around the ill-fated mini-budget. Whilst we would stop short of sounding the all-clear, this is an encouraging sign. The rally has stalled at the 3% level, roughly where 10Y yields were in early September.

Spreads to 10Y Bund are back to just above 120bp but the Treasury rally has brought that spread to -25bp after a trough of -50bp. More cuts being priced out of the GBP curve would bring the spread to Bund to 100bp but we think Treasuries would outperform in any rally, meaning we can no longer exclude Treasuries trading through gilts.

More cuts being priced out of the GBP curve would bring the spread to Bund to 100bp

Unlike the USD curve, the focus on rate cuts in 2024 is nothing new. What's interesting is that forwards have inverted more even as hikes were being priced out. This is a notable development because one would expect that higher hikes now also mean less room to cut later. In any event, we think this forward curve inversion is only a transitional state of affairs until either the dovish re-pricing shaves more hikes off the front-end, or more stubborn inflation contradict cut expectations.

At 3%, gilts could still tighten to Bund but we think Treasuries would outperform in a rally



Source: Refinitiv, ING

Sterling will struggle to make further gains

The BoE's trade-weighted measure of sterling has recovered nearly 8% from its lows in September and is now trading back to levels seen in early August. It looks as though about half of that rally has come from the improvement in the UK's fiscal credibility since the dark days of September. And the other half has come from the broad sell-off in the dollar, where the US currency makes up about 20% of the BoE's sterling basket.

We doubt Thursday's BoE meeting will have too much impact on sterling, where a 50bp hike looks priced. But heading into 2023, we suspect sterling will struggle to make substantial further gains. Here, we doubt GBP/USD can sustain gains over the 1.23 area given our view that the next sizable move in the dollar is probably stronger as the Fed stays hawkish through the first quarter of next year, in spite of the looming recession. And we feel that EUR/GBP will find good support below the 0.85/86 area and favour a return to the 0.87/88 region. Here two-year euro versus sterling swap spreads should remain pretty steady in the 130-150bp area. But a call on a challenging investment environment – central banks hiking into recessions – suggests sterling should under-perform given its higher sensitivity to global equity markets.

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