

Bank of England to press ahead with tightening

The Bank of England will add a third hike to its tally in this cycle. We think it is likely to pause and reflect once the Bank Rate reaches 1%, and gilt sales begin. Hiking expectations are excessive – an inverted yield curve reflects this – but long rates could climb further. EUR/GBP has probably seen its low this year and will rise into year-end



BoE to proceed with front-loaded hiking cycle

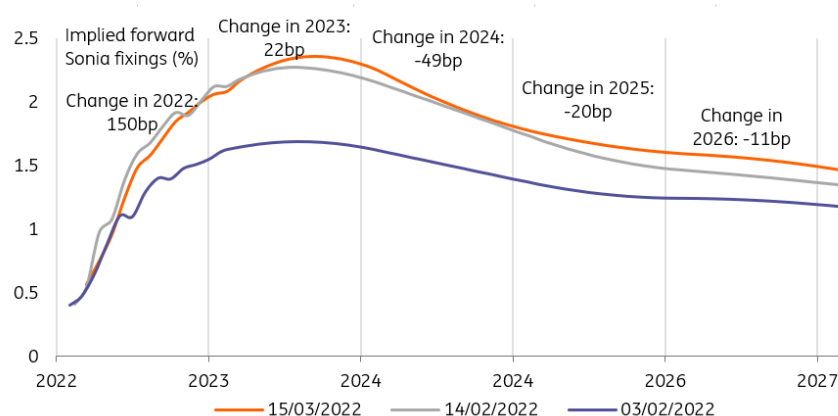
The war in Ukraine means that [UK inflation is going to stay higher for longer](#). It's likely to peak at 8% in April but could peak even higher later in year should energy prices surge higher once more. Markets have concluded that this means the Bank of England will double-down on its tightening plans. And in the short-term investors are probably correct, in that we'd expect the Bank to hike rates for the third time this week, and probably again in May. Policymakers have made it abundantly clear that they want to get some pre-emptive tightening done to mitigate against their concerns about higher inflation rates becoming more sustained.

8% The peak in UK CPI

to be reached in April

However, we suspect the Bank will opt for another 25bp rate rise this week, rather than a larger 50bp move. While four out of nine policymakers voted for such a move back in February, the remainder of the committee indicated that they worried such a move would simply add further fuel to market interest rate expectations. Markets are pricing even more tightening than they were back then – six rate hikes in total this year. Comments from officials have offered some modest pushback against these expectations, and we may well see more of this on Thursday.

Sonia swaps already price an aggressive hiking cycle



Source: Refinitiv, ING

Our own view is that after a couple more rate hikes, the committee is likely to pause and put greater emphasis on the deteriorating growth backdrop. After all, such a sharp rise in oil and gas prices is more likely to be medium-term disinflationary, even if it keeps headline inflation rates higher this year.

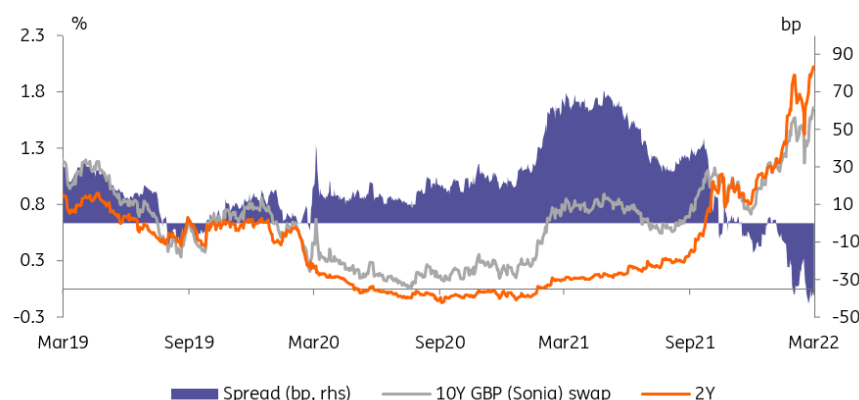
After a couple more rate hikes, the committee is likely to pause

Remember too that as of May, assuming Bank rate hits 1% as we expect, policymakers have signalled they may start actively selling assets to accelerate [the Quantitative Tightening process](#). While the committee would probably like to separate this process as much as possible from rate hikes, it is a policy potentially fraught with risks – not least how the Bank would avoid selling assets into a sharp risk-off period. As such, we think the start of this process would be another argument in favour of pausing hikes from the spring.

Rates markets: too much tightening priced in but some upside to long end rates

Rates markets go into the March BoE meeting rightly expecting the BoE to add a third hike in this cycle. As things stands, the Sonia curve implies a small chance of a 50bp hike, but we think this is a marginal view among market participants. By any account, the amount of tightening the BoE would have to deliver to prove current valuations right is ambitious. Despite repeated hints from MPC members, this discount hasn't shrunk. The question is, what would it take for it to reverse?

The inverted GBP curve means the BoE is getting nearer the end of its cycle



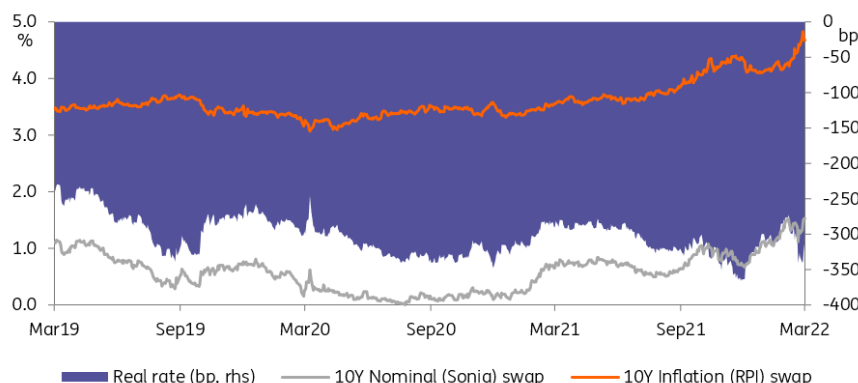
Source: Refinitiv, ING

One problem is that BoE hike expectations aren't happening in a vacuum. Other DM central banks edging closer to their own hiking cycle (with the Fed also likely hiking this month) means hawkish pricing remains the path of least resistance. Sterling rate markets are in a different position than their dollar peers, however. The BoE has already hiked twice, so the 'pre-emptive' part of its tightening is already well underway, and markets are thus more likely to pay attention to the growth risk of higher energy prices.

Markets are more likely to pay attention to the growth risk of higher energy prices

In this context, an inverted yield curve (in the forwards but also in some spot tenors) makes sense. It is either consistent with the BoE being forced into tightening more than the economy can stomach, and thus causing a recession, or with the view that the BoE will be closer to the end of its tightening cycle than to the beginning after this week's hike. Whichever is true (we think the latter), this state of play could be reversed by a more cautious tone at this meeting, for instance if the camp in favour of 50bp hikes shrinks compared to February, or if the BoE signals more strongly that inflation should drop below 2% within its forecast horizon.

Nominal swaps have lagged inflation expectations, pointing to more upside



Source: Refinitiv, ING

Even so, long end nominal rates still have room to rise in the near-term, led by real rates. The difference between nominal and inflation swap rates is still well below its February peak, by 27bp, and below what one would expect well into a central bank tightening cycle, by over 100bp compared to the previous cycle. In practice this is likely to be reversed by a convergence of inflation and nominal swaps but this signals that swaps have not yet seen the peak in this cycle.

FX: EUR/GBP should be making a low this year

Like many currencies, Sterling has witnessed a wild ride over recent weeks and realised volatility is back to levels last seen in early 2021. EUR/GBP made it very close to 0.8200 in early March but has since recovered quite strongly.

For the last six months or so we have taken the view that the BoE would welcome Sterling strength as a means to insulate against higher imported energy prices. We suspect that this is still the case, but for Sterling to stay strong the BoE will have to keep aggressive tightening expectations alive. As discussed above, the key question for financial markets this Thursday is how aggressively the BoE wants BoE tightening expectations re-priced?

Unless the BoE issues a strong rates protest on Thursday, we suspect EUR/GBP can continue trading in the 0.8300-0.8400 range. But a return to 0.8200 looks like something of a stretch now. And as we move into the second half – and assuming the ECB is ready to start tightening in 4Q22 – EUR/GBP should be starting to turn higher. As we outline on our [FX forecasts page](#), EUR/GBP may be putting in a significant low near 0.82 this year and could be trading nearer 0.88/90 into 2024.

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

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.