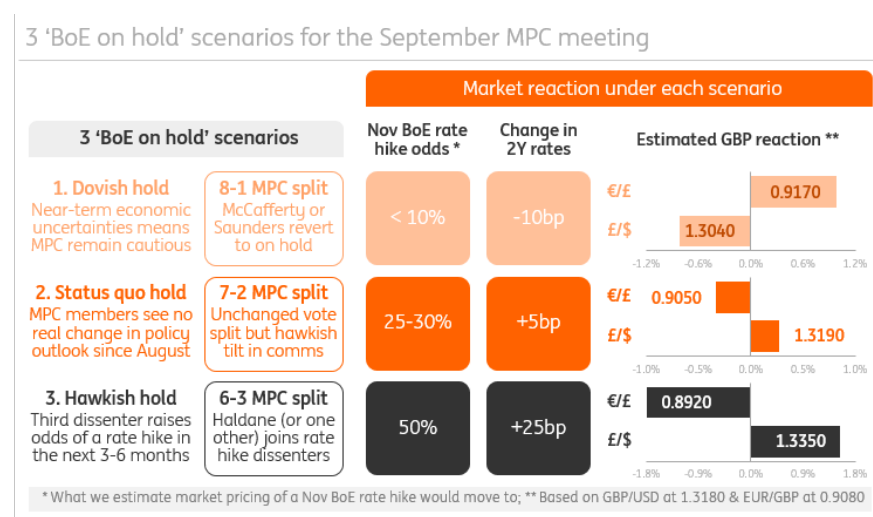


GBP: Time for the BoE to take charge

While the Bank of England is widely expected to keep policy unchanged on Thursday, we look for two signals that could mark a positive turning point in GBP sentiment and end the 'Great British Sell-off' in currency markets



Source: Source: ING estimates

September BoE preview: Our 5 Key Messages

- Greater risks of a 6-3 MPC vote split and a third member joining the dissenting ranks this week (likely Chief Economist Andy Haldane); in this scenario, we would expect the odds of a November BoE rate hike to increase to 50:50
- Expect BoE to signal explicit concerns over the UK rate curve being too flat, the intent being to realign the currently benign market expectations with the narrative of a gradual tightening path over a 2-year horizon
- Inflationary pressures from renewed GBP weakness may, for some MPC members, tilt the growth-inflation policy trade-off in favour of an earlier than anticipated reversal of the post-Brexit emergency monetary stimulus
- The combination of more robust UK inflation signals in the latest round of CPI and labour market data releases - as well as a hawkish tilt at the September BoE meeting - could mark a positive turning point in GBP sentiment
- We are now starting to see the risk premium related overshoot in EUR/GBP unwind; a hawkish hold at this week's BoE meeting could fuel a further correction towards - and

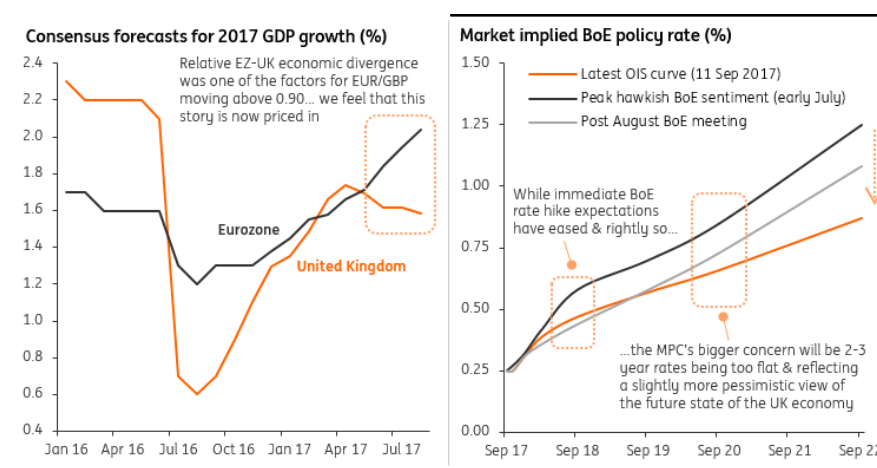
potentially below - the 0.90 level, which would almost certainly shelve any EUR/GBP 'parity' fears for now

Our analysis in the final section of the note estimates GBP's reaction more broadly under 3 BoE 'on hold' scenarios (dovish hold, status quo hold, hawkish hold)

1 Signal 1: Market implied policy rate curve is too flat

We believe that BoE officials may use the policy statement, accompanying minutes and vote split this week to try and shake up market expectations for the path of policy. Based on the UK OIS curve, implied market pricing suggests that there is a barely 1 in 4 chance of a 25bp Bank rate increase this year, which rises to only a 65% probability by the end of 2018. Likewise, surveys of households and businesses suggest that few anticipate meaningful increases in interest rates anytime soon.

While policymakers may be less concerned about the repricing of immediate rate hike expectations, what may be making some on the MPC nervous is the flattening bias over the 2-3 year part of the curve (see RHS panel of chart below). This is indeed starting to look at odds with an economy where inflation is set to rise close to 3% and economic growth remains positive, if somewhat subdued.



Source: Source: Consensus Economics, Bloomberg

Engineering a steeper UK rate curve

The minutes of the August MPC meeting stated that if the economy followed a path similar to the one the BoE anticipated "then monetary policy could need to be tightened by a somewhat greater extent... than the path implied by the yield curve". This sentiment has been repeated in several subsequent BoE speeches and is likely to remain within the accompanying text.

However, while this message may provide a backstop to any further flattening of the UK rate curve, we suspect that any meaningful uplift in short-term rates is unlikely to be achieved unless there is a hawkish shift in the vote split.

Any meaningful uplift in short-term rates is unlikely unless we get a third MPC member calling for an immediate rate hike

External members Ian McCafferty and Michael Saunders will likely again vote in favour of an immediate 25bp rate rise, but the key story will be whether BoE Chief Economist Andy Haldane finally follows through with his threat to vote for a hike. Back in June, he warned that “the balance point [between tightening ‘too early’ and ‘too late’]... has shifted. Certainly, I think such a tightening is likely to be needed well ahead of current market expectations.”

With this week's data flow set to show headline inflation jumping back to 2.8%, wage growth edging higher and employment growth remaining robust, there is the clear potential for a 6-3 MPC vote split – with a third dissenter joining the ranks.

Such a vote could prompt a reappraisal of the potential path for UK interest rates, while also providing a knee-jerk boost to GBP. However, we feel that the economic uncertainty brought about by Brexit will likely lead the MPC to hold fire until there is much greater clarity in the UK's post-Brexit investment environment - which may not transpire until the turn of the year. Moreover, even if we do see last August's emergency rate cut reversed at some point over the next six to twelve months, our message would be that it is unlikely to mark the start of a pronounced tightening cycle.

For more on the different types of BoE tightening paths, see our note [GBP: What if the Bank of England does hike?](#)

2 Signal 2: Weak GBP tilting policy trade-off in favour of stimulus withdrawal

As we [flagged last week](#), the GBP trade-weighted index hovering above the 74 level - and close to historic lows - had entered a territory that may require greater attention from policymakers (the BoE's "danger zone"). While the trade-weighted index has rebounded sharply to above 75 over the past week, we acknowledge that were it to stay at these depressed levels, then in isolation, it will result in an upgrade to the BoE's inflation projections at the next forecast round in November.

We wouldn't be surprised to hear greater BoE noise over sterling weakness at this week's meeting, primarily in terms of what this means for inflation overshooting the 2% target and whether the growth-inflation policy trade-off has altered for some MPC members. The following subtle changes in the statement could signal that the balance of risks may be tilting towards an earlier than anticipated withdrawal of the post-Brexit emergency monetary stimulus:

- **Recent GBP weakness may prolong the squeeze in households' real incomes story.** Back in August, one of the MPC's key assumptions was that the peak effect of GBP-induced inflation may now be behind us and that real wages were likely to recover. However, the combination of renewed currency weakness and still subdued wage growth means that the squeeze in households' real incomes story may persist for longer than previously anticipated. Hence, some MPC members may see greater economic costs of ultra-loose monetary policy.
- **Risks are that inflation picks up beyond 3% later this year.** For some MPC officials, 3%

inflation may be the implicit line in the sand where the growth-inflation trade-off starts to tilt in favour of an earlier than anticipated withdrawal of the current emergency stimulus policy backdrop. While there is clear evidence that domestically generated inflationary pressures remain soft, we could start to see references to GBP weakness and imported inflation having "second-round effects" (eg, risks of rising imported input costs feeding through to domestic prices more meaningfully).

- **Pronounced GBP weakness may have adverse consequences for inflation expectations.** While market-based inflation expectations are far from becoming "de-anchored", we do note that both the five- and ten-year inflation breakevens have been on an upward trend since early August. The tail risk at this week's meeting would be if some members start to cite upside risks to inflation expectations stemming from a weak currency.

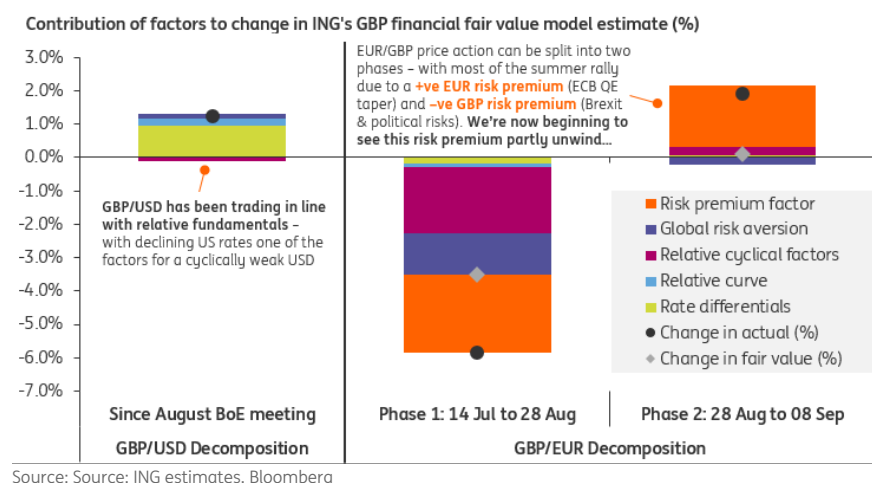
Overall, we believe that such "weak pound" references in the context of BoE policy talk could draw a line under any significant GBP-selling pressures in the near-term.

Decomposing GBP weakness since August

We attribute GBP's weakness since the August BoE meeting to a narrower focus on upcoming Brexit and domestic political risk events, as well as markets adjusting to a weaker UK economic outlook. Both factors now look to be adequately priced into the currency; as the below chart shows, the relative cyclical and risk premium channels were the biggest contributors to GBP's pronounced weakness against the EUR earlier this summer.

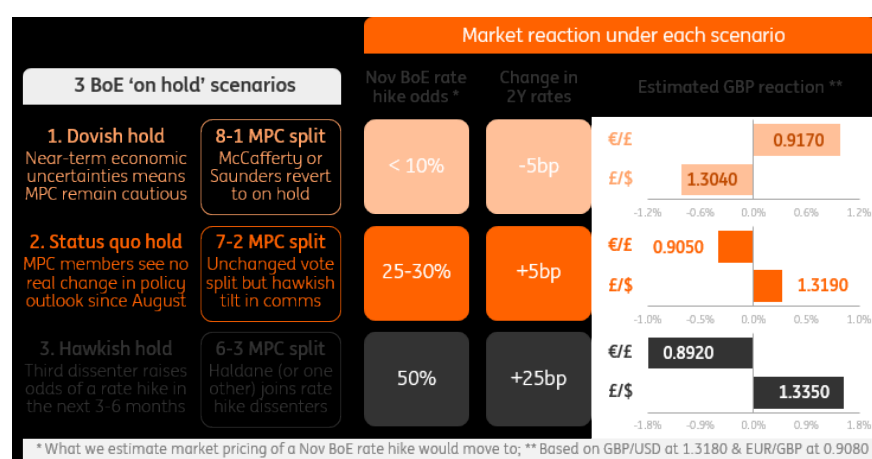
However, with ECB QE speculation priced into the EUR and UK political risks unlikely to notch up another gear in the immediate future, we're now starting to see the overshoot in EUR/GBP unwind. We believe that a hawkish surprise at this week's BoE meeting could fuel a further correction towards - and potentially below - the 0.90 level. This would reinforce our broader view that a [EUR/GBP move towards parity remains very much a longshot](#) at this stage.

The bottom line is that while GBP had a fairly dismal August, we believe the combination of more robust UK inflation signals in the latest round of CPI and labour market data releases - as well as a hawkish tilt at the September BoE meeting - could mark a positive turning point in GBP sentiment. Our BoE scenario analysis below shows that the extent of GBP's initial recovery this week will be a function of how much, if at all, short-term UK rates move higher. But in the absence of any further escalation in UK political risks, we look for GBP to embark on a broader corrective phase over the next couple of weeks.



3 'BoE on hold' scenarios for the September MPC meeting

- Dovish hold (8-1 MPC vote split):** Should one of the current dissenters (McCafferty or Saunders) revert back to a hold vote, then we would expect short-term UK rates to fall close to 10bp and GBP to move lower against both the EUR and USD. Risks are that EUR/GBP could further overshoot and test the 0.9180-0.9200 highs in this scenario.
- Status quo hold (7-2 MPC vote split):** This would be broadly in line with market expectations, making this week's BoE meeting a non-event. A slight hawkish tilt in the statement and accompanying MPC communications could inject a small upward bias in UK rates and GBP, though we would expect any market reaction to be fairly short-lived.
- Hawkish hold (6-3 MPC vote split):** Were we to see a third MPC member – most likely Chief Economist Andy Haldane – join the rate hike dissenters, we think market expectations for a November BoE rate hike could pick up to 50% (currently c.20%). A sharp move higher in UK rates could see GBP rally by around 1.0-1.5%; under this scenario, EUR/GBP could clear the 0.9000 handle and move down to as low as the 0.8920/50 region, while GBP/USD could test the 1.3350 level last seen almost a year ago (Sep-16).



Author

James Knightley

Chief International Economist

james.knightley@ing.com

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