Markets are right to rethink the Bank of England as rates reach a peak

Investors have significantly reappraised the Bank of England outlook over recent weeks, and we think rate hikes have now finished. Rate cuts are likely to be a story for next summer

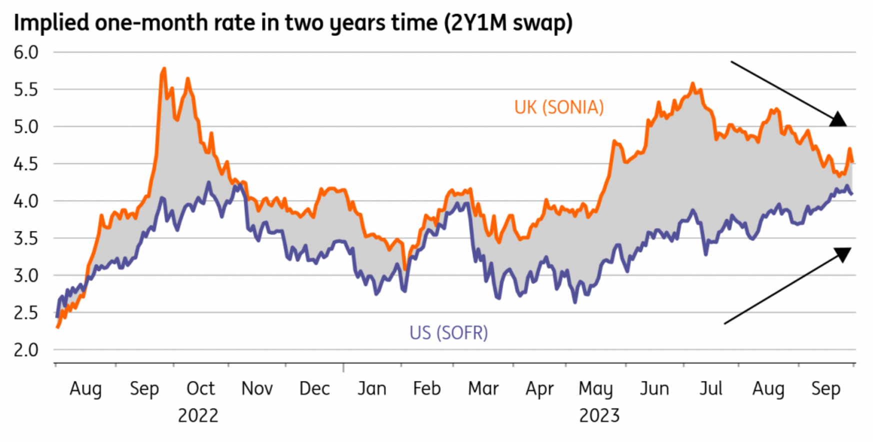
Bank of England governor Andrew Bailey says there's 'no room for complacency'.

Investors have revised down UK rate expectations over recent weeks

Against a backdrop of rising US market rates, it’s all the more eye-catching that UK rate expectations continued to fall back through September. The differential between US and UK rates has narrowed considerably as a result, and if we look at where investors expect rates to be in two years’ time, the Bank of England is expected to have rates only fractionally above the Federal Reserve. Contrast that with July, where at one point markets were pricing UK rates two full percentage points higher than across the Atlantic in mid-2025.

It's a big move, and it is at least partly a recognition that the UK’s inflation problem isn’t considerably worse than elsewhere – a narrative that had become fashionable earlier in the summer. The most recent inflation figures came in well below expectations, and even if some of that was noise, it’s a reminder that disinflation is coming to Britain just as it has in Europe and the US.

UK rate expectations have fallen even as they've risen in the US



Source: Macrobond

We think hikes have finished and cuts can begin next summer

Markets are also responding to the Bank of England itself, which, having paused rate hikes in September, has effectively called the top in this tightening cycle. Barring a big data surprise between now and the November meeting, we think the Bank's August rate hike was the last.

That turns the focus to rate cuts, and the Bank is at pains to tell us that these are a long way off. We agree, up to a point. Services inflation – a key metric for the Bank – is likely to end the year below 6% from 6.8% now and continue falling thereafter as lower gas and electric prices work through with a lag. Wage growth is likely to do the same, though in both cases the decline will be gradual. Economic inactivity (people neither employed nor actively seeking a job) is on the rise again, and the employment rate is still a percentage point lower than pre-Covid. Worker shortages aren't going to go away entirely.

That said, the jobs market is now clearly beginning to cool. The ratio of job vacancies to unemployed workers is falling quickly, both because of a fall in openings but also a noticeable rise in joblessness. The BoE is also acutely aware that much of the impact of past rate hikes is yet to hit. The average rate on outstanding mortgages has risen from 2% to 3% and will be above 4% probably by the spring of next year. That's why the Bank is keen to keep rates high for a long period, but we think by next summer the case for maintaining rates at 5% or above will have faded. Assuming the Fed has started cutting rates by that point, we've pencilled in the first cut in August 2024.

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