

## Rates and FX are waking up to a less hawkish Bank of England reality

Markets are expecting too much tightening from the Bank of England and are slowly waking up to a less hawkish reality. This means gilts will struggle to follow Treasury and Bund yields higher, and the curve should price out hikes. Sterling has started to react to the weaker consumer data and, barring a very hawkish surprise, risks look skewed to the downside



Sterling has started to react to weaker consumer data and risks look skewed to the downside

[We're expecting the Bank of England to hike in May and June](#), but the tone is turning more cautious. The BoE's voting pattern and lower growth forecast should be hints that hike expectations at the front-end of the curve are excessive. As the central bank hits the pause button in the summer, we expect markets to wake up to the less hawkish reality.

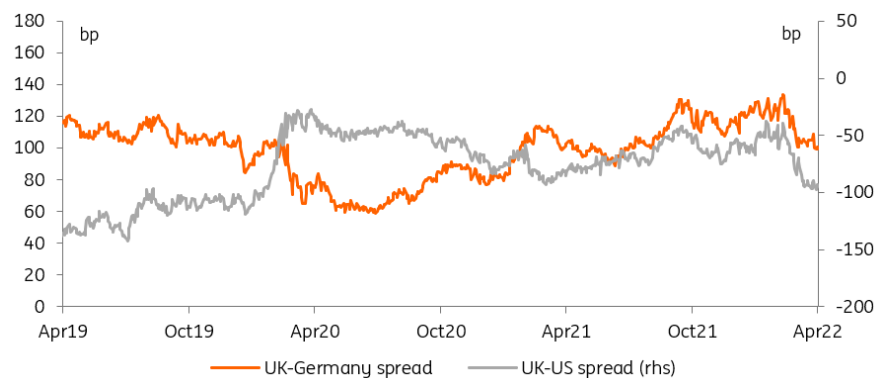
### The gilt canary in the coal mine

After months of being at the forefront of the core rates market sell off, with a clear underperformance in H2 2021 relative to US Treasuries and German Bund when the BoE ramped up its hawkish message, gilts are now warning that the sell off is running out of steam. A string of

weak sentiment data had the market re-rate recession probabilities, and gave weight to the comparatively cautious tone adopted by the BoE.

Breaking 2% to the upside remains a possibility for 10Y gilts but we expect them to continue to lag Bund and USTs if bond selling resumes. We foresee yields ending 2022 at 1.8% and the rally should accelerate next year. We also caution that [impaired liquidity conditions in the gilt market make outright selling by the BoE less likely](#) in the near term.

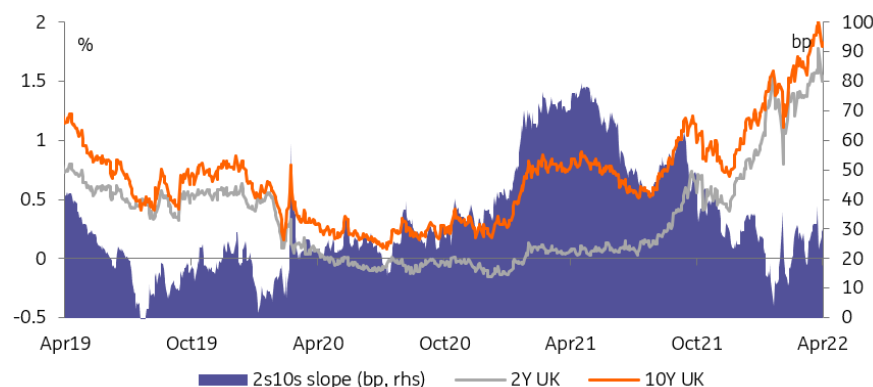
## Gilt spread tightening to Bund and Treasuries reflect the worsening economic outlook



Source: Refinitiv, ING

The UK is far from being the only economy with a worrying growth trajectory, and we should eventually see German Bund and US Treasuries catch up to the gilt rally. Our best guess is that will happen in the third quarter this year once the Fed has a few hikes under its belt and once inflation has stabilised. It is however noteworthy that, after being ahead of the pack when it came to tightening, it now looks as if the BoE has the luxury to adopt a more prudent approach when inflicting more policy tightening to its domestic economy.

## The gilt curve should re-steepen once hike expectations deflate



Source: Refinitiv, ING

We have been warning for months that the policy rate path implied by GBP swaps looked too aggressive, but that a turaround was only likely once the BoE tightening cycle is well underway.

*The gilt curve should re-steepen helped by deflating rate hike expectations*

Hike expectations have now started to come off, but we think this is only the beginning of the adjustment lower. This has started a race between front and back end rates. We think curve dynamics will depend on when global yields peak. If we're right in seeing a few more months of global bond sell-off, then the gilt curve should re-steepen during the same period, also helped by deflating rate hike expectations.

## Our 4 scenarios for the May BoE meeting and expected market reactions

Bank of England actions/comments			
Decision	Growth/inflation	Future tightening	Market impact
① No rate hike	Bank dramatically revises down growth forecasts, expects recession over summer. Wage pressures set to cool	Drops guidance that further 'modest' rate hikes are likely	EUR/GBP: <b>0.8600</b> 10Y yield: <b>1.60%</b>
② 25bp rate hike 6-3 vote in favour	More committee members join Cunliffe in voting against another hike as concerns about cost of living/growth build	Forecasts clearly imply that, based on market rate hike pricing, inflation will undershoot	EUR/GBP: <b>0.8500</b> 10Y yield: <b>1.70%</b>
ING base case			
③ 25bp rate hike 8-1 vote in favour	Inflation revised up but negative economic growth now expected. Unemployment set to gradually rise	Reiterates more 'modest' hikes coming and risks either way. Bank opts against starting active gilt sales	EUR/GBP: <b>0.8450</b> 10Y yield: <b>1.75%</b>
④ 50bp rate hike	Price pressures broadening out and wage growth too quickly. Justifies faster front-loaded tightening	Little/no pushback against market pricing of six more hikes this year. Active gilt sales to begin	EUR/GBP: <b>0.8250</b> 10Y yield: <b>1.90%</b>

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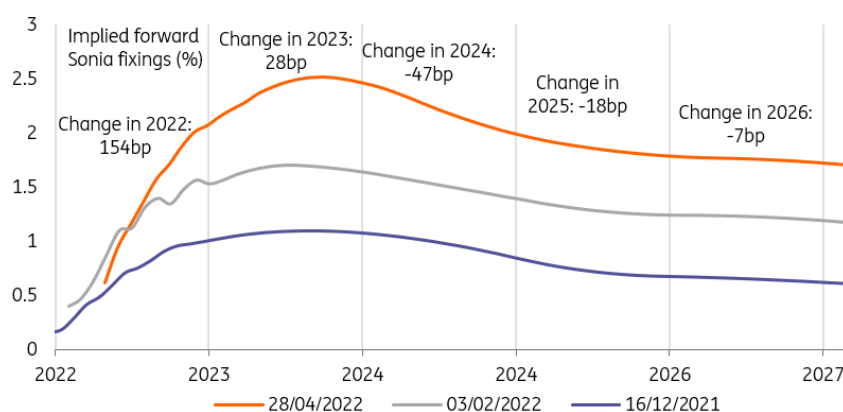
## FX: Waiting for the penny to drop

Sterling has had a bad week at the office. The Bank of England's broad trade-weighted measure of the pound has sold off 2% over the last week as a combination of: a) weak UK consumer data and b) a much tougher risk environment on the pincer movement of higher US real rates and weaker Chinese growth prospects. Incidentally, GBP/USD has had one of the highest G10 FX correlations with global equities over the last few months.

## Sterling has had a bad week at the office

In looking at the various EUR/GBP reactions to the four BoE scenarios outlined above, we have used our Financial Fair Value (FFV) model as a guide. This identifies key drivers of EUR/GBP pricing such as yield differentials, the shape of the UK yield curve and the equity environment as inputs. The problem is those yield differentials have lost some of their explanatory power recently. In fact, one has to go back to earlier in 2021 when say a 5bp move in the GBP:EUR yield two-year differential was worth about a 1% move in EUR/GBP.

### A re-pricing lower of hike expectations means GBP could take a leg lower



Source: Refinitiv, ING

Assuming that the beta on the yield differential driver is lower, we present more conservative EUR/GBP levels in our scenario analysis above. Our baseline scenario sees some modest GBP weakness - e.g. EUR/GBP to 0.8450 on the BoE event risk. But James Smith has been making his case that the BoE Bank Rate will end the year at 1.25% as opposed to the 2.15% currently priced by the market. If and when that penny drops, GBP could take another large leg lower and GBP/USD may end up far closer to the 1.20 level than we had originally forecast.

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