

The UK inflation story is starting to turn a corner

Markets expect the Bank of England to lag behind the Federal Reserve when it comes to rate cuts. But with the story on UK inflation slowly turning a corner, we think markets are overestimating the potential divergence between these two central banks



Andrew Bailey, Governor of the Bank of England, pictured at King Charles III's Coronation in May

Markets expect the Fed to cut rates more aggressively than the Bank of England

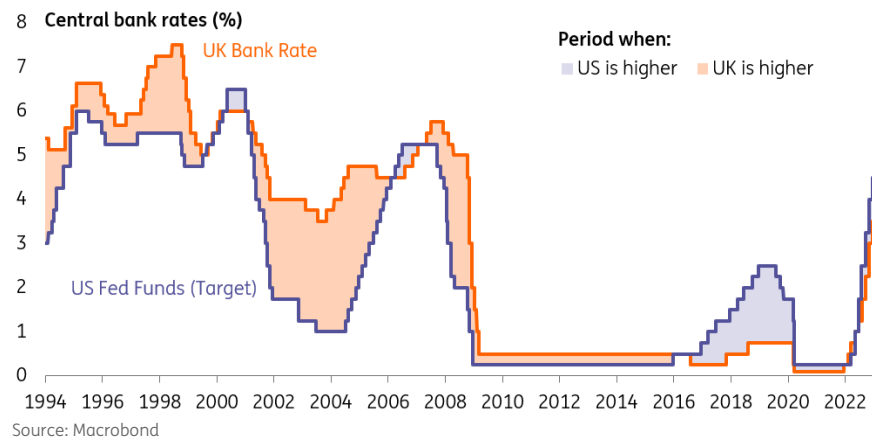
Not for the first time in this central bank tightening cycle, an interesting divergence is opening up in the way investors are viewing the future path of rate hikes/cuts from the Bank of England relative to elsewhere. Where 200bp of rate cuts are now priced in the US over the next couple of years, investors are looking for just half that in the UK. And unlike the Federal Reserve, investors think the BoE still has rate hikes left in the tank before the summer.

Admittedly this divergence, if it plays out that way, wouldn't be new. The Fed was ahead of the game with rate cuts in 2007/08, while the US tightening cycle seen through 2017/18 was not replicated in the UK.

But to see the same kind of divergence this time around we think would imply that the banking

crisis is likely to have a much greater impact on the US than Europe and/or that inflation will prove much stickier.

Bank of England divergence from the Federal Reserve is far from unprecedented



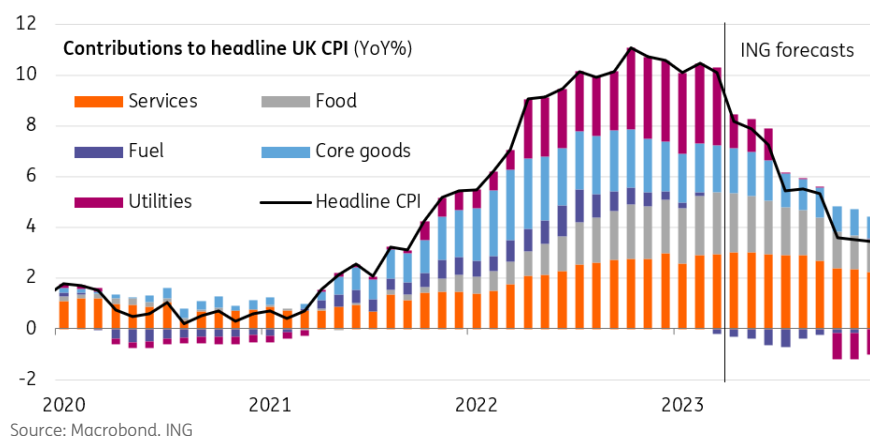
The UK inflation story is starting to turn a corner

On the former, so far we've not seen the same degree of tightening in lending standards in the Bank of England's Credit Conditions survey as we've seen in the Fed's Senior Loan Officer report. But equally, it's highly unlikely that the UK economy would be fully insulated from a US recession triggered by tighter lending conditions.

On inflation, there are reasons to think US inflation will fall more aggressively, or at an earlier stage, than in the UK and we're already seeing that. Partly that's a consequence of the UK's exposure to Europe's energy crisis, and it's also just a simple reflection of the much lower weight on housing/rent in the British inflation basket.

Still, the news on UK inflation is looking slowly better. Admittedly the most recent wage and CPI data came in higher than expected, though the former has been volatile and the latter is mainly down to food and "core goods", neither of which, by the BoE's own admission, are likely to be long-lasting trends. The BoE's own survey of chief financial officers shows both wage growth and price-setting expectations having fallen for a few months now.

UK inflation set to fall dramatically this year



Bank of England rate cuts coming in early/mid 2024

The worry of BoE hawks is that services inflation – the part of the basket that tends to be slower-moving – could stay higher for longer. But at 6.7%, we think we’re virtually at the peak and it should go below 5% by the year-end. That’s still uncomfortable and could be a catalyst for the Bank to hold rates as the Federal Reserve begins to cut. But much of the rise in service sector inflation can be traced back to higher gas prices, which are now considerably lower. That, and the potential for slower wage growth, point to a further fall in services inflation through 2024.

We therefore expect rate cuts to begin after Easter in 2024, and this easing cycle could ultimately see Bank Rate fall below 3%. That means that, over a two-year horizon, the BoE may not look that different to the Fed after all.

Author

James Smith

Developed Markets Economist, UK

james.smith@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 <http://www.ing.com>.