What if the Bank of England does hike?

Four charts showing what the tail risk scenario of an Aug BoE rate hike would mean for the pound

Source: Bank of England

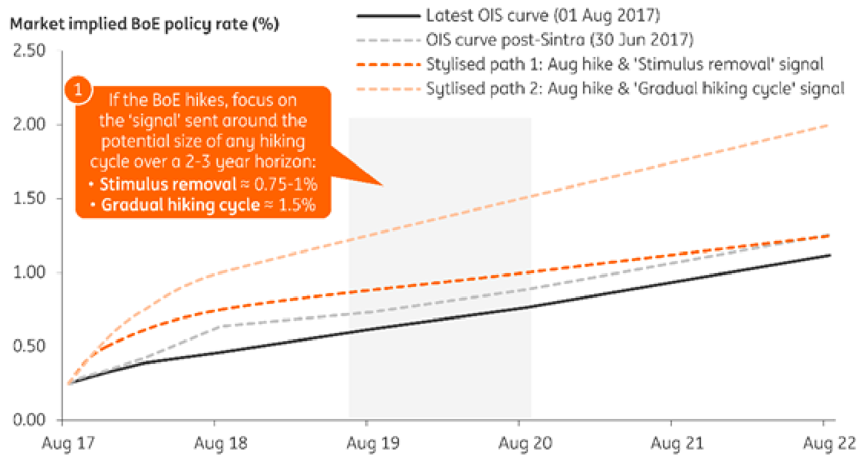
Focus on the 'signal' around the scope and extent for additional BoE hikes

While a Bank rate hike today would come as a surprise to markets - and would see a knee-jerk move higher in short-term UK interest rates and the pound - we think what matters once the dust settles is the underlying motivation for any BoE tightening. It may more be prudent to focus on the 'signal' sent around the potential scope and extent for further rate hikes over a 2-3 year horizon - as this is where markets will ultimately gravitate towards.

We think there are two types of signals to consider:

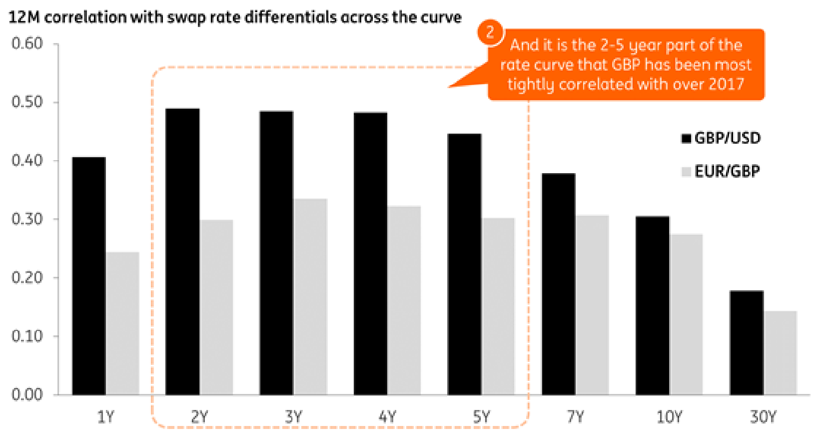
- "Stimulus removal" which should be interpreted as a 'one (or two) and done' type of hiking cycle
- "Gradual hiking cycle" which is a more flexible and open-ended BoE normalisation path that would inevitably result in a steeper market curve

If anything, we would expect the BoE to signal something closer to the former and any rate hike to be moderated with strong dovish forward guidance aimed at keeping market expectations in check.



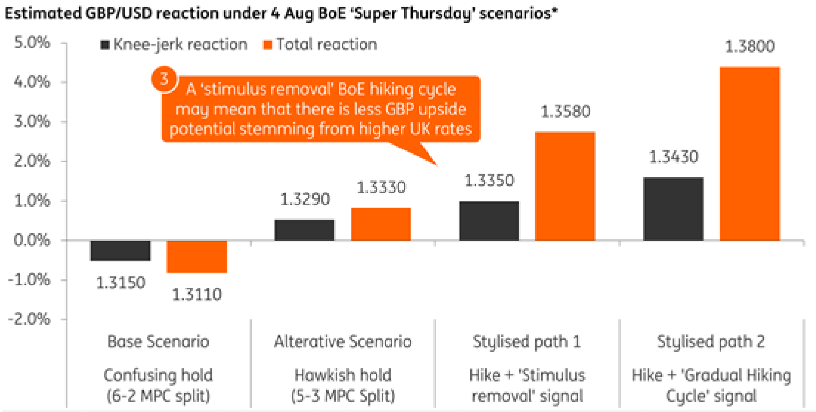
Short-term interest rate differentials mattered more for GBP in recent months

More importantly, it is the 2-5 year part of the curve that GBP/USD - and to a lesser extent EUR/GBP - has been most tightly correlated with over the past year. Therefore, focusing on the interim end-point for the Bank rate may be more rewarding when calibrating GBP upside potential as a result of BoE tightening.



A 'stimulus removal' BoE hiking cycle would have subdued impact on GBP

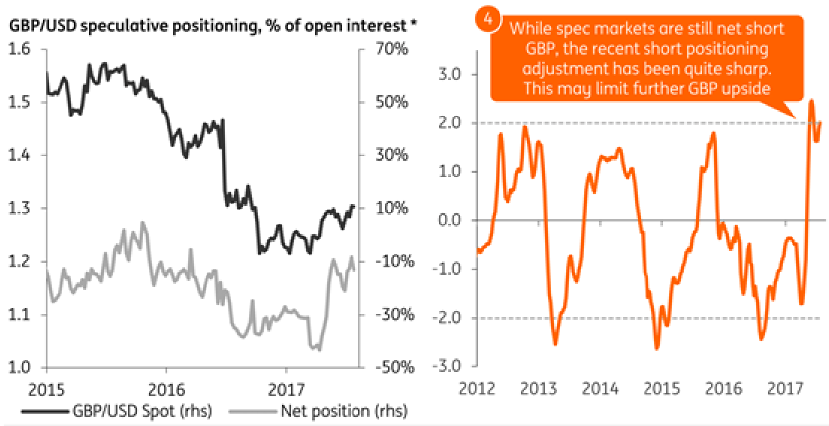
Even if the BoE surprises with a rate hike today, forward guidance in line with our "stimulus removal" hiking cycle scenario is likely to limit the extent to which GBP can move higher. We estimate that GBP/USD could move up to 1.35-1.36 but would face strong resistance here in the absence of a very hawkish BoE. A similar analysis for EUR/GBP shows that we could see a retreat to 0.8800. It is worth noting that our estimates are based on an isolated move in short-term UK rates - and makes the assumption that US and Eurozone rates remain constant at current levels.



*Note spot reference: 1.3320. Our analysis for EUR/GBP based on spot at 0.8950 shows total moves to 0.8800 (Path 1) and 0.8720 (Path 2)

Recent positioning adjustment supports case for more muted GBP rally

While speculative markets are still net short GBP – at around levels seen a year ago – the recent short positioning adjustment (partly a function of a weak USD) has been quite sharp. Our normalised z-score analysis of GBP positioning shows that markets are short-term bullish going into the BoE Super Thursday event. Therefore, while there is still overall scope for short GBP positions to be squeezed further, the recent positioning adjustment may limit the extent to which GBP could rally in the event of a BoE surprise hike today.



*Note: CFTC data as of 25 Jul 2017. RHS chart is based on ING's normalised z-score analysis of CFTC positioning data