Our view on this week's biggest central bank decisions

The Federal Reserve, European Central Bank and Bank of England are set to raise interest rates again this week but the size of the hikes and tone of the guidance could be very different. Our economists share their thoughts on what to expect and what it could all mean for economic growth and financial markets

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Persistently high wage and service-sector price inflation points to another 50bp rate hike from the Bank of England next Thursday. If we're right,...

By James Smith and Chris Turner

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Federal Reserve: Back to 25bp hikes as slowdown fears mount

Last year saw the most aggressive policy tightening path in four decades, but Fed officials have laid the groundwork for more modest 25bp hikes in...

US Federal Reserve Chair Jerome Powell

25bp with more still to come

Having raised the Fed funds target range by 425bp in 2022, including 75bp and 50bp moves, expectations are firmly centred on the Federal Reserve opting for a more modest 25bp interest rate increase on Wednesday – taking the target range to 4.5-4.75%. While inflation is still well above target and unemployment is at a cycle low, there are signs that the economy is responding to tighter monetary policy and the Fed will be cognisant of fears that hiking rates too hard and fast risks toppling the economy into recession.

Officials certainly appear to be backing "standard" 25bp increases from now on after enacting their most aggressive hiking cycle for 40 years, but most are warning that there is still more work to be done. Consequently, we expect to hear that ongoing interest rate hikes are "appropriate" with the balance sheet shrinking strategy remaining in place.

Scenarios for the Federal Reserve meeting

Scenario analysis: The Federal Reserve's alternatives

	Inflation outlook	Growth outlook	Interest rates	Quantitative Tightening	24 hour reaction 10Y Treas (3.50%)	24 hour reaction EUR/USD (1.09)
Current stance	Fed "highly attentive" to inflation risks" and "strongly committed" to 2%	Require a "sustained period of below-trend growth"	Target rate range at 4.25-4.50%, ongoing interest rate increases "appropriate"	Monthly balance sheet reduction \$60bn of Treasuries, \$35bn MBS		
Dovish	Over tightening could lead to a sharper, deeper fall in inflation	Recessionary forces are building, early signs of cooling jobs market	**25bp** with future hikes being "data dependent"	Discussion of potential slower reduction in balance sheet	3.35	1.10
ING Base Case	Inflation is too high, but monetary policy works with long & varied lags	Growth is slowing, but the jobs market is strong and the focus is on inflation	**25bp hike,** ongoing interest rate increases "appropriate"	Unchanged	3.50	1.08
Hawkish	Inflation is proving to be stubborn with risks still weighted to the upside	Need a prolonged period of below trend growth to bring inflation down	**50bp hike** with ongoing interest rate increases "appropriate"	Unchanged	3.65	1.07
Very hawkish	Inflation is embedded and upside risks justify ongoing rate hikes	Recession required to have a material impact on inflation outlook	**50bp** Fed signals clear intent to crush inflation	Announcement of swifter balance sheet reduction	3.80	1.05

Source: ING

Officials are unlikely to switch to a "data dependency" narrative just yet, fearing that adopting too dovish a line could fuel market expectations for eventual rate cuts. In turn, this could lead to an unwanted loosening of financial conditions that contribute to inflation staying higher for longer.

Conversely, signalling 25bp but then hiking by a more aggressive 50bp would generate a large risk-off reaction with sharply higher borrowing costs. The majority of the committee would likely consider this too risky an option given the potential to intensify recessionary forces that could end up excessively dampening inflation.

With no new Federal Reserve forecasts at this meeting, the accompanying press conference is likely to re-affirm that it is appropriate to move in smaller 25bp steps from now on and we are not at the endpoint yet.

The Fed could over and/or under-hike other rates for technical reasons, but likely won't

Apart from the headline funds rate range of 4.25% to 4.50%, the Fed will also adjust higher the rate on the reverse repo facility and on excess reserves. These are currently at 4.3% and 4.4% respectively, and are often seen as the tighter corridor within which the effective fed funds rate sits (currently 4.33%).

There is constant speculation on the likelihood of the Fed deciding to under-hike the rate on the reverse repo facility, to bring it to flat to the fed funds floor (it's currently 5bp over). The logic would be to encourage less use of this facility, which routinely takes in US\$2tr in excess liquidity on a rolling daily basis. However, in all probability, repo would simply trade down to the same area, without a material effect on volumes.

There is a similar argument to instead over-hike the rate on excess reserves, say by 30bp (instead of 25bp). The idea here would be to encourage a downsize in the use of the reverse repo facility in place of an upside in bank reserves (higher relative remuneration). This would allow the Fed to better manage bank reserves, ensuring that it doesn't fall too fast, as it gradually ratchets its balance sheet lower through the ongoing soft quantitative tightening programme (as it allows

$95bn of bonds per month to roll off the front end).

In all probability, it won't do this either. It is already a 10bp spread between the reverse repo window and the excess reserves one, and widening that to 15bp might not make a material difference. That said, a spread of 20bp just might, and is something the Fed could consider down the line i.e. under-hiking the reverse repo rate and over-hiking the rate on excess reserves. On this occasion, there would be quite a surprise if it did anything along these lines, at least not at this juncture.

The Fed could also upsize the quantitative tightening agenda, but likely won't either

The Fed has also been quite quiet on the balance sheet roll-off programme. It seems that's the way it likes it – churning away quietly in the background, and not causing too many market ripples. The big question in this space is whether the Fed could consider outright selling some bonds off its books, and thereby engage in a harder version of quantitative tightening. It would be huge if it did. There is certainly an appetite for bonds in the market if the recent Treasury auctions are anything to go by.

However, such selling of bonds outright would likely be a step too far at this juncture, as it would likely generate a tantrum. But it's always there should the Fed start to feel that the fall in longer-dated market rates is acting contrary to its hiking efforts on the front end. Even a mention that it is looking at this down the line would have a material effect. Not expected, but these are potential market movers that we need to cross off as the meeting outcome unfolds.

Importantly, any mention of potentially upsizing the bond roll-off in the future or considering any bond selling (e.g. of the longer-dated mortgage portfolio) would signal it was uncomfortable with where longer-dated market rates are at.

But the outlook is darkening and the peak is close

We think that the Fed will probably hike once more on 22 March, but that will mark the top for the policy rate. We are concerned that signs of a slowdown will spread and intensify with a recession our baseline forecasts.

Residential construction has fallen in each of the past six months, industrial production has been down for the past three months and retail sales have dropped by 1% or more in both November and December. Unfortunately, business surveys offer no hint of a turn with both the manufacturing and service sector ISM indices in contraction territory and the Conference Board's measure of CEO confidence at the most depressed level since the Global Financial Crisis – a clear signal that businesses will be focusing more on cost-cutting rather than revenue expansion this year.

At the same time, the heavy weighting of shelter and vehicles within CPI and clear signs of softening corporate pricing power mean that inflation will be close to 2% by the end of this year. Rents have topped out in most major cities while vehicle prices are now falling, with the National Federation of Independent Businesses survey on price intentions pointing to a sharp slowdown in core inflation through the second quarter into the third quarter of this year.

As for the jobs market, while headline payrolls growth remains impressive there are flashing warning lights with the temporary help component reporting falling employment numbers in each of the past five months. This is concerning because this grouping of workers is typically easier to hire and fire by the nature of the position so they tend to lead broader shifts in payrolls.

Worryingly, the declines are getting bigger each month, suggesting the momentum in the jobs market is souring. In an environment of weak activity, falling inflation, and mounting job losses, we doubt the Fed will raise rates beyond March with rate cuts the order of the day from the third onwards.

FX: Things are getting interesting

It has been pretty much one-way traffic for the dollar bear trend since early November. Clear signs of easing US price pressures and a slowing economy have upended the prior narrative of a Fed forced to tighten into a recession. Risk assets have rallied strongly.

Data shows that the EUR/USD six-hour reaction to last year's Federal Open Market Committee (FOMC) decisions triggered moves of anywhere between +/- 0.7%. And the FX options market has a 90 pip range priced for EUR/USD over the period which covers both the Fed and the ECB meetings next Wednesday/Thursday.

We were about to say that an expected 25bp rate hike from the Fed and a relatively unchanged statement would have little impact on FX markets. Yet we have just seen FX markets move on the Bank of Canada's decision to halt its tightening cycle at 4.50%. The dollar was marked lower on this decision, presumably on the minority view that the Fed could also be ready to call time on its tightening cycle.

This suggests that the FOMC meeting could prove more interesting than the market has priced. Our base case would assume that EUR/USD continues to trade near 1.08/1.09 after the FOMC meeting. Any suggestion that the Fed was virtually done tightening could send EUR/USD through 1.10. While aggressive Fed push-back against the 50bp of 2023 easing already priced by the market could briefly send EUR/USD to 1.07.

In the bigger picture, we expect EUR/USD to head higher this year – perhaps to the 1.15 area in the second quarter – this will be the time when US inflation is falling more sharply and China re-opening is providing a tailwind to the pro-cyclical currencies, including the euro.

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ECB preview: Still licensed to hike

When the European Central Bank meets next week, all eyes and ears will once again be on the communication. A rate hike of 50bp looks like a done deal. How...

Recent economic data in the eurozone offers a taste of what will increasingly become a new challenge for the ECB: a somewhat more resilient than expected economy, improving sentiment indicators and dropping headline inflation. While the growth part argues in favour of more rate hikes, lower inflation could argue in favour of taking a step back given that the central bank's primary mandate is to reach price stability. For next week, however, both developments are too fresh and tentative for the ECB to change course. Instead, the ECB looks set to hike interest rates by another 50bp. There has not been a single ECB member on the record with a diverting view.

Risk of longer-lasting inflationary pressure

The reason for a 50bp rate hike is clear: the ECB’s job is far from done as the Bank's own December projections pointed to inflation at 3.4% in 2024 and 2.3% in 2025. Inflation was only expected to return to 2% in the second half of 2025. These estimates have provided a clear license to hike for quite some time. The only problem with these forecasts is that they are highly conditional on the so-called technical assumptions for interest rates, energy prices and exchange rates. At the December press conference, the ECB stated its discontent with the market pricing of future rate hikes, hoping for higher pricing, which would mechanically lower the ECB’s inflation forecasts. With energy prices much lower than in December, the exchange rate stronger and interest rates higher, back-of-the-envelope estimates show that, if everything else remains the same as it was in December, the ECB's headline inflation projections could easily be lowered by 0.3 to 0.5 percentage points for 2024 and 2025.

Looking beyond next week's meeting, as long as core inflation remains stubbornly high and core inflation forecasts remain above 2%, the ECB will continue hiking rates. The increasing probability that a recession will be avoided in the first half of the year also gives companies more pricing power, as reflected in January's PMI, showing that selling price expectations remain elevated. The celebrated fiscal stimulus, which has eased recession fears, is an additional concern for the ECB as it could transform a supply-side inflation issue into demand-side inflation. These are two factors that could extend inflationary pressures, albeit at a lower level than currently, in the eurozone.

More hikes to come but communication needs improvement

More generally speaking, we are currently witnessing a mirror image of the ECB up until 2019. Back then, the Bank had a clear easing bias and was chasing disinflation with all means possible, even though the root causes for disinflation lay outside of the ECB's realm. Now, the ECB has a clear tightening bias and is chasing inflation, which arguably also has its root cause in something the ECB cannot tackle. Still, it looks as though the current generation of ECB policymakers will only back down once they are fully convinced that inflation is no longer an issue. In this regard, the slight improvement of the eurozone's growth prospects as well as abundant fiscal stimulus have given the Bank even more reason to continue with its hawkish mission.

With all of the above in mind, it is hard to see the ECB cutting interest rates again any time soon. Current market expectations about ECB rate cuts in 2024 are premature. If anything, these expectations, as reflected in dropping longer-term interest rates, are an additional argument for the ECB to stay hawkish. However, sounding hawkish will not be enough. Recent weeks have once again illustrated that the ECB's communication is suboptimal. Over the last 12 months, there has been forward guidance, meeting-by-meeting, focusing on actual inflation, inflation projections, core inflation, wages, financing conditions etc, etc, etc. But communication is always a two-way street. If ECB policymakers are not satisfied with how financial markets perceive their communication, they might need to ask themselves why this is happening and reflect on the messages they have been sending.

Still licensed to hike

For next week, the ECB remains licensed to hike. We expect hawkish comments by ECB President Christine Lagarde in order to prevent another drop in market interest rates. In this regard, it would help if the ECB were to clarify its reaction function and send a message that has a longer shelf life than just a few days.

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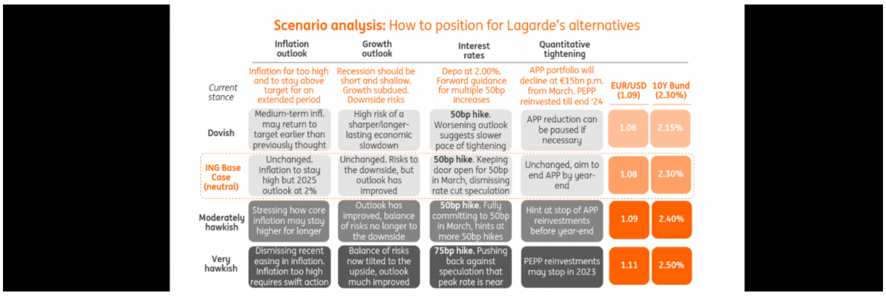
ECB cheat sheet: Wake up, this isn't the Fed!

A 50bp hike by the European Central Bank, and a repeat of its December guidance, are set in stone but a pushback against subsequent cut expectations will...



Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	Quantitative tightening	EUR/USD (1.09)	10Y Bund (2.30%)
Current stance	Inflation far too high and to stay above target for an extended period	Recession should be short and shallow. Growth subdued. Downside risks	Depo at 2.00%. Forward guidance for multiple 50bp increases	APP portfolio will decline at €15bn p.m. from March. PEPP reinvested till end '24		
Dovish	Medium-term infl. may return to target earlier than previously thought	High risk of a sharper/longer-lasting economic slowdown	**50bp hike**. Worsening outlook suggests slower pace of tightening	APP reduction can be paused if necessary	1.06	2.15%
ING Base Case (neutral)	Unchanged. Inflation to stay high but 2025 outlook at 2%	Unchanged. Risks to the downside, but outlook has improved	**50bp hike**. Keeping door open for 50bp in March, dismissing rate cut speculation	Unchanged, aim to end APP by year-end	1.08	2.30%
Moderately hawkish	Stressing how core inflation may stay higher for longer	Outlook has improved, balance of risks no longer to the downside	**50bp hike**. Fully committing to 50bp in March, hints at more 50bp hikes	Hint at stop of APP reinvestments before year-end	1.09	2.40%
Very hawkish	Dismissing recent easing in inflation. Inflation too high requires swift action	Balance of risks now tilted to the upside, outlook much improved	**75bp hike.** Pushing back against speculation that peak rate is near	PEPP reinvestments may stop in 2023	1.11	2.50%

Source: ING

Front-end pricing talk but it's a red herring

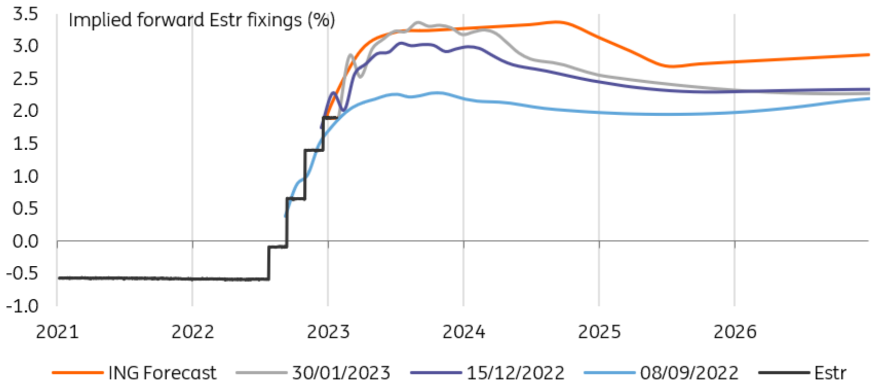
Much has been said and written about the next two ECB meetings' rate hikes. The upshot is, as our colleagues highlight, the ECB still has a licence to hike, and a 50bp increase is pretty much set in stone this week. In all likelihood, guidance for a 50bp March hike will be repeated too but the March meeting will also feature a new set of forecasts that should heavily influence the ECB's decision. As a result, markets will be tempted to rely more on their anticipation of how the ECB staff forecast will evolve at that meeting, rather than on president Christine Lagarde's guidance.

> *In all likelihood, guidance for a 50bp March hike will be repeated*

As our economics team noted in their preview, "If everything else remains the same as it was in December, the ECB's headline [March] inflation projections could easily be lowered by 0.3 to 0.5 percentage points for 2024 and 2025". Cut-off for the FX, rates, and energy market prices is a little under one month away but, as things stand, this would imply 2025 inflation at 1.8%, under the ECB's 2% target. Worse, this would be premised on a curve that implies 80bp of cuts between the mid-2023 rate peak and end-2024.

To cut a long story short, we wouldn't overstate the importance of the next two meetings for interest rates markets.

We now have more hawkish ECB expectations than the market



Source: Refinitiv, ING

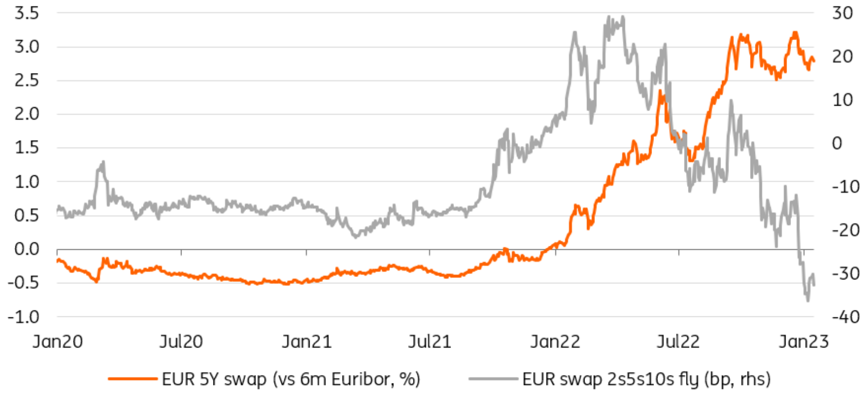
Eyes on the prize, the belly's where the battle really is

The curve is pricing a rapid decline in rates after they reach their peak in 2023. For a central bank expected to hike at least three more times, this is problematic. Lagarde is sure to be asked about this anomaly. If recent history is any guide, she'll likely take that opportunity to guide market rates higher. We doubt she'll manage to completely dis-invert the curve, however. The shape of the euro term structure cannot be seen entirely in isolation and some remnant of easing is likely to persist as long as the Fed is expected to cut more than 200bp by end-2024. But, at least, she should manage to delay cut expectations.

The part of the curve most likely to be affected is the 5Y point. We think hike expectations are correctly set for the next few meetings which imply that short-dated bonds and swaps, say up to 2Y, are also correctly priced. Longer tenors, on the other hand, depend on more structural factors such as where investors think the long-term interest rate equilibrium lies. This is not something the ECB will change at this meeting. This leaves the maturity in between, aptly called the belly of the curve, as the sector most at risk of a pushback against cut expectations.

What happens to the slope of the curve, for instance 2s10s, depends in greater parts on the tone of the ECB from one meeting to the next. We have a view (it will be hawkish) but given its recent unpredictability, we have a greater conviction on our outright (higher rates) and curvature (5Y rates to rise faster than other maturities) calls.

5Y rates are most at risk if the ECB pushes back against rate cut expectations



Source: Refinitiv, ING

'Detailed parameters' on quantitative tightening to come, but the market-moving information is already out

The ECB has promised "detailed parameters" for the reduction of its asset purchase programme portfolio. With laying out the headline volumes already at the last meeting, the most market-moving aspects are already known. What we could expect is details about whether the reduction will be proportionate across the different asset classes. Within the public sector specifically, how the ECB will maintain alignment with the capital key distribution across countries. We do not anticipate the ECB to diverge from previous targets here, though we might get information on how special situations will be dealt with. For instance when overall redemptions in a month are below the targeted reduction volumes.

A rebalancing towards supranational debt with their larger share of green bonds would make sense

Keeping in mind the focus the ECB and Isabel Schnabel in her recent speeches have put on "greening" the central bank's portfolios, there is a chance that this also translates into more concrete action in the public sector portfolio. A rebalancing towards supranational debt with their larger share of green bonds would make sense, and it would not impact the capital key alignment. It would also address the rising prominence of the European Union as an issuer. We doubt though that such tweaks by themselves will impact the market's currently benign take on sovereign spreads. This time they are more likely to take their cues from the overall tilt of the ECB's communication.

This isn't a litmus test for the euro rally

While it's undeniable that the ECB doubling down on its hawkish rhetoric has contributed to the strengthening of the euro since December, we don't see this week's policy meeting as a litmus test for the sustainability of the euro rally.

The reasons are two-fold. First, EUR/USD may well return to being predominantly a dollar story this week. A Fed approaching peak rate and facing a worsening economic outlook has more room to surprise on the hawkish side, and we think it could offer a breather to the dollar. In contrast, as discussed above, we would not overstate the importance of the next two ECB meetings for rates.

> *The ECB's communication hiccups have likely eroded the market's trust in Lagarde's guidance*

This leads us to the second reason: the ECB's communication hiccups have likely eroded the market's trust in Lagarde's guidance. Only a few hours after the December meeting, the news that many members had preferred 75bp was leaked. And if ECB members aligned behind the 50bp guidance in recent weeks, a probably more debated 50bp move in March may well cause sparse communication again after the February meeting. This – in our view – may lead markets to be more forward-looking than what Lagarde will wish them to be.

Ultimately, data may remain a larger driver than Lagarde's guidance for the euro. If gas prices stay capped and economic surveys keep pointing up, a correction in EUR/USD after a hawkish Fed should not last long. We expect EUR/USD to trade around 1.07-1.10 for most of February. Another big break higher may need to wait for an official pivot by the Fed: we see this materialising in the second quarter, where we forecast a move to 1.15.

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FX | United Kingdom

Four Bank of England scenarios for February's meeting

Persistently high wage and service-sector price inflation points to another 50bp rate hike from the Bank of England next Thursday. If we're right,...

Governor of the Bank of England, Andrew Bailey

Four scenarios for the Bank of England meeting

Bank of England actions/comments			Market impact
Decision	Outlook	Future tightening	(GBP/USD: 1.2360) (10Y yield: 3.32%)
1 **25bp rate hike** Votes: 75bp (0) 50bp (0) 25bp (7) no hike (2)	Impact of previous rate hikes still largely to hit the economy. Says that services inflation set to slow markedly despite tight jobs market	Suggests that no further rate hikes are required	GBP/USD: **1.2100** 10Y yield: **3.05%**
2 **25bp rate hike** Votes: 75bp (0) 50bp (2) 25bp (5) no hike (2)	Sizable recession still expected. Inflation forecasts revised down slightly through 2023	Keeps door open to 50bp hike if needed. But forecasts hint markets are overestimating required tightening	GBP/USD: **1.2200** 10Y yield: **3.20%**
ING base case 3 **50bp rate hike** Votes: 75bp (0) 50bp (6) 25bp (1) no hike (2)	Growth revised up on lower gas prices & more modest market rate expectations. Services inflation to stay elevated	Prepared to act 'forcefully' if needed. Hints that market pricing on rate hikes is in the right ballpark	GBP/USD: **1.2350** 10Y yield: **3.25%**
4 **50bp rate hike** Votes: 75bp (1) 50bp (7) 25bp (1) no hike (0)	Growth revised up heavily. 2-3 year inflation forecasts lifted on persistent wage pressure	Strong hint at another 50bp hike in March. Explicitly says markets are being too quick to price rate cuts	GBP/USD: **1.2500** 10Y yield: **3.45%**

Source: ING

Market pricing based on spot values on 27 January

The Bank of England looks more likely to follow the European Central Bank than the Federal Reserve next Thursday, and we expect a 50 basis point rate hike for the second consecutive meeting. While the minutes of the December meeting appeared to open the door to a potential downshift to a 25bp move in February – and this meeting looks like a closer call than markets are pricing – the reality is that the recent data has looked relatively hawkish.

Wage growth is persistently high, looking both at the official numbers and the BoE's own business surveys. Headline inflation came in a little lower than the Bank projected back in November, but services CPI – seen as a better gauge of domestically-driven inflation – has come in above expectations.

Still, if we get a 50bp hike on Thursday then it's likely to be the last. BoE officials have hinted previously that much of the impact of last year's rate hikes is yet to hit, and cracks are forming in interest-rate-sensitive parts of the economy. Headline inflation should begin to come down more rapidly from March too, as the impact of last year's energy bill surges drop out, and core goods/food pressure begins to ease more noticeably.

We expect one final 25bp hike in March, taking the Bank Rate to a peak of 4.25%. The key question for Thursday is whether the Bank itself acknowledges its work is nearly complete. We suspect it's more likely to keep its options open.

Here's what we expect:

1 The vote split

December's meeting saw the number of policymakers voting for a 75bp hike drop from seven to one, and the committee's two most dovish officials opted for no rate hike at all. The lesson then and throughout 2022 was that the committee tends to move by consensus, and that means that the vote split is unlikely to be particularly narrow, even if the meeting is a tough one to call. Either we'll get a similar number of officials voting for 50bp again, or we'll see the vast majority scale back their vote to 25bp, akin to the kind of shift we saw in December.

Our base case is that we see six of the nine policymakers voting for a 50bp hike, one for 25bp and two for no change.

How each official has voted on interest rate decisions since 2021

	Hawks								**Doves**
	Mann	Haskel	Ramsden	Pill	Bailey	Broadbent	Cunliffe	Tenreyro	Dhingra
Dec 21	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.00%	
Feb 22	0.50%	0.50%	0.50%	0.25%	0.25%	0.25%	0.25%	0.25%	
Mar 22	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.00%	0.25%	
May 22	0.50%	0.50%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	
Jun 22	0.50%	0.50%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	
Aug 22	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.25%	
Sept 22	0.75%	0.75%	0.75%	0.50%	0.50%	0.50%	0.50%	0.50%	0.25%
Nov 22	0.75%	0.75%	0.75%	0.75%	0.75%	0.75%	0.75%	0.25%	0.50%
Dec 22	0.75%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.00%	0.00%

Source: Bank of England, ING

Dr Swati Dhingra joined the committee in August 2022 and began voting in September

2 New forecasts

Calmer markets and scaled-back rate hike expectations since the mini-Budget crisis last year mean we shouldn't be surprised to see the Bank upgrade its growth forecasts. Lower gas prices should theoretically help too, though this is a little more awkward for the BoE given that the government hasn't yet cancelled plans to increase household bills in April, even if such a move now looks unlikely. That also means we'll have to take the new inflation forecasts with a slight pinch of salt, and our own view is that headline CPI will end the year 1pp lower if April's planned increase is scrapped and consumer bills return to levels consistent with market pricing from the third quarter.

Still, it's the medium-term story that matters more. Keep an eye on the so-called 'constant rate' inflation forecasts, where the Bank assumes the Bank rate will remain unchanged from now on. If these show inflation at, or very close to, 2% in a couple of years' time, then that would be a sure-fire sign that policymakers think we're close to the peak for Bank Rate.

3 Guidance on future policy decisions

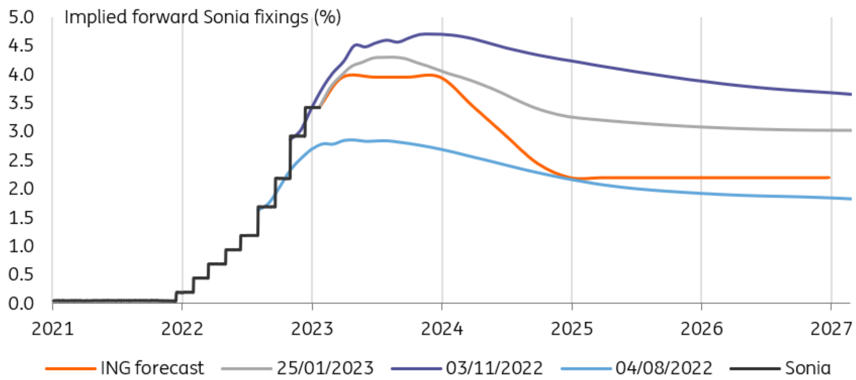
Governor Andrew Bailey hinted recently that current market pricing, which sees a peak for Bank Rate at 4.4%, is in the right ballpark. That suggests little reason for the Bank to rock the boat too much on Thursday with new forward guidance, and we suspect it will want to keep options open.

The Bank will likely repeat that it's prepared to act 'forcefully' in future if required (though we learnt in December's minutes that 50bp hikes classify as 'forceful'). We also doubt Bailey will be willing to be drawn on whether the Bank could pivot back to a 25bp hike in March, nor indeed whether that would be the last move in the cycle. Where he may be tempted to push back is on policy easing, especially now markets are almost pricing in one 25bp rate cut by the end of this year. Chief Economist Huw Pill's recent emphasis on the UK sharing the worst bits of the US and eurozone's inflation problems – structural labour shortages with the former, the energy crisis with the latter – feels like a line we'll hear a lot over the coming months as officials try to dampen expectations of policy easing.

Sterling rates to tighten to euro, and a more inverted curve

The sterling rates curve still trades with a remnant of the risk premium that appeared in the run-up to the September budget debacle, making it one of the few markets where we think rates are unjustifiably high. Things have changed since then, however. Markets have come around to our more benign view on the terminal rate in this cycle, now implying hikes will stop around 4.25%. Instead, the discrepancy is to be found in longer maturities where the curve implies the Bank rate will remain elevated longer than at other central banks.

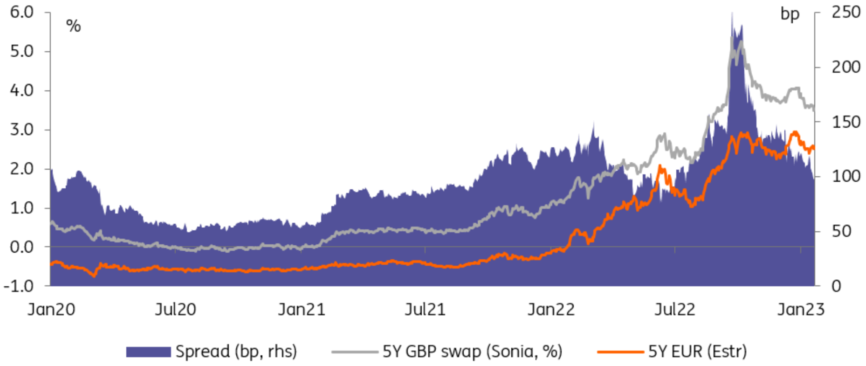
What markets expect from the Bank of England over the coming months



Source: Refinitiv, ING

That markets taking a more hawkish view of BoE policy than signalled, for instance in its forecast, is nothing new. What's changed is the way participants look at inflation risk. This has prompted yield curves to take a much more benign view of Fed and ECB policy. Each country is different but we find the treatment of sterling rates increasingly at odds with that of the dollar and euro. As a result, we expect the differential between 5Y sterling and euro swap rates to shrink to 75bp. This convergence should also be helped by the worsening of UK economic surprise indices, just as their eurozone equivalent goes from strength to strength.

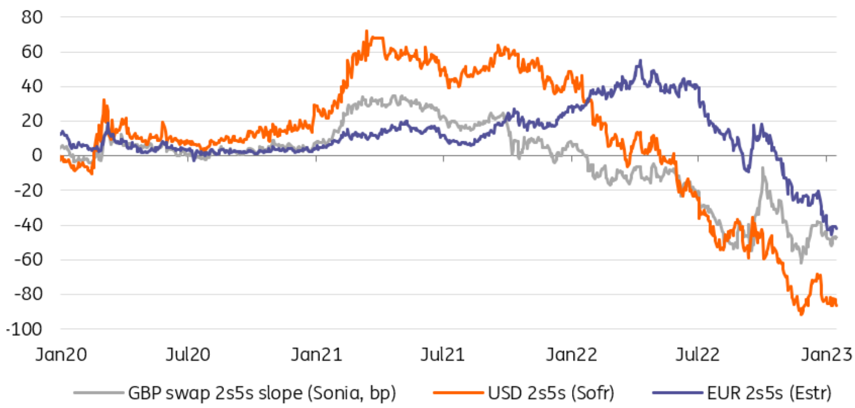
The spread between euro and sterling swap rates is likely to narrow



Source: Refinitiv, ING

We also think the GBP curve is due to flatten further. One likely driver is the market's growing confidence that the BoE, like the Fed, will soon be in a position to cut rates, although we wouldn't expect this before 2024. Another less probable driver would be if the BoE feels the need to tighten policy more than expected in the coming meetings. We very much doubt that longer rates would follow the short end higher, pricing instead a growing risk of rate cuts down the line to cushion the economic hit.

We think the GBP curve is due to flatten further



Source: Refinitiv, ING

GBP: Temporary strength

The BoE's broad trade-weighted measure of sterling has bounced around 6% since the dark days of September and will marginally ease the BoE's fears of imported inflation. Given that a 50bp hike is not fully priced for Thursday, sterling could enjoy some limited and temporary strength should the BoE indeed hike 50bp. Depending on the post-FOMC state of the dollar, that could briefly send GBP/USD back into the 1.24/25 range and EUR/GBP back to the low 0.87s.

However, the challenges facing sterling have not gone away. Large twin deficits, weak growth and what throughout the year should be building expectations that falling prices – especially from

March/April onwards – will provide room for the BoE to cut rates around the turn of the year.

In terms of a profile, we think a continued narrowing in GBP rates premium to the EUR can push EUR/GBP higher through the year towards the 0.90/91 area. GBP/USD should be supported by the better EUR/USD trend, but will probably struggle to hold any gains to the high 1.20s – potentially seen in the second quarter.

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