

Bank of England cuts rates in dramatic meeting

The Bank of England has cut rates by a further 25 basis points to 4% but the statement hints that officials think the easing cycle is nearing its end. Policymakers are visibly worried about a more persistent bout of inflation as the headline number is way higher than target. For now, though, we're sticking to our call of another cut in November



Bank of England
Governor, Andrew
Bailey

4%

Bank of England base rate

0.25% cut

The Bank is heavily divided

Is the Bank of England's rate-cutting cycle nearly at an end? That is certainly one interpretation of the latest decision, which, despite cutting rates by a further 25 basis points, sounded considerably more hawkish than expected.

The Bank has included a new line in its statement, stating that "*the restrictiveness of monetary policy has fallen as Bank Rate has been reduced*". A statement of the obvious, perhaps, but markets have taken it as a cue to price a higher end point for this easing cycle. There are now barely two cuts priced by next summer, and no further moves this year.

Policymakers are evidently becoming wary about echoes of 2022, where a spike in food and energy prices prompted a much longer-lasting episode of higher inflation. Bank officials have recently cited research showing that inflation has a tendency to become more entrenched when headline rates exceed 3.5-4%. And the BoE's newly updated forecasts have headline CPI sitting within that range for the rest of this year. Food inflation, which has picked up recently, is clearly going to be a key driver of policy at the next few meetings.

What's also striking is just how unfazed the Bank is by recent pressures in the jobs market. Yes, hiring conditions have clearly cooled. But the fact that the payroll data is falling only gradually – and that it is highly concentrated in hospitality – suggests there's no smoking gun right now that would mandate more aggressive policy easing.

We're sticking to a November rate cut - for now

We still think the Bank's concerns about inflation will prove overblown. There's no reason in and of itself that inflation will become more entrenched, simply because headline CPI is sitting above target. It relies on workers being able to chase higher wages, as they bid to retain purchasing power. And it relies on firms having sufficient pricing power. The power of households and businesses to do that has clearly faded as the jobs market has cooled.

We'd also note that a lot of what's driving inflation right now is inherently backwards-looking and/or heavily linked to regulated price rises. There are good reasons to think inflation will ease off in 2026.

That said, so long as wage growth and services inflation stay where they are - close to 5% - there's little reason to think the Bank's view will change imminently. That's unless the jobs market were to show more visible signs of deterioration, of course.

Our base case has for some time been that the Bank would cut rates again in November and twice more next year. And for all the hawkish rhetoric, it's worth noting that the Bank's new forecasts, which have inflation perfectly on target in two years' time, are premised on two further rate cuts.

We're sticking to our call, but were the next couple of inflation reports to surprise to the upside, or if the recent falls in private-sector employment start to ease off, then we'll be rethinking.

Close call on the rate cut sees sterling bounce

The close decision to cut rates today and the 6-7bp jump in short-dated sterling swap rates has sent EUR/GBP around 0.5% lower. Today's communication has put a little distance between market views on the Fed and BoE policy easing, where the former looks set to embark on a renewed easing cycle in September, while the latter is telling us that rates may be closer to neutral than first thought.

Recent EUR/GBP bullishness has partially been premised on the view that the BoE had some 75bp of easing to complete, which may not be the case now. Today's developments probably mean that EUR/GBP can linger in the 0.86-0.87 area a little longer, perhaps as the BoE rides out the run-up in

headline inflation over the coming months with careful rhetoric.

But assuming that softening conditions in the UK labour market and lower inflation allow the BoE to cut rates towards 3.50% next spring or summer, we'd expect EUR/GBP to be comfortable near 0.88. And our early call for end 2026 levels is closer to the 0.90 area as the market starts to price the first ECB hike in early 2027.

For GBP/USD, this surprise hawkishness from the BoE cements the importance of the recent low at 1.3150 and suggests sterling can fully take advantage of dollar weakness into year-end. This could see GBP/USD pushing into the 1.36/38 area – assuming UK data does not deteriorate too dramatically in the last quarter.

In the bond market, we've seen some modest bearish flattening, with two-year Gilt yields +5bp and the longer end up 2-4bp. It's not clear whether there's been some disappointment on the Quantitative Tightening story, where investors had been positioned for some good news (lower QT amount, switching issuance to shorter maturities) in the September announcement.

The Monetary Policy Report did have a box on QT today, but the main takeaway seemed just to be that QT had had a slightly larger impact, +15-25bp, on the term premia in Gilts than the +10-20bp previously expected. Not enough to provide any big clues as to what gets announced in September.

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