Bank of England opts for smaller rate hike after better inflation news

The Bank of England is keeping all its options open on future rate hikes, although another rise in September seems highly likely. Whether that's repeated in November is a more open question, particularly if services inflation starts to fall more noticeably between now and then

Campaigners wearing masks of Bank of England Governor Andrew Bailey and Prime Minister Rishi Sunak outside the Bank of England on 3 August

Bank of England reverts back to a 25bp hike

Better news on inflation has, as expected, enabled the Bank of England to pivot back to a 25 basis-point rate hike this month. That follows a more aggressive 50bp hike back in June.

Policymakers clearly don't want to come across as complacent though, and there are plenty of references to the upside risks associated with inflation, as well as the recent surprises in wage growth. We shouldn't be too surprised then that the Bank isn't offering up much on what it intends to do next.

The BoE retained its forward guidance that says it could hike again if "evidence of more persistent pressures" shows up in the inflation figures. This is the same phrase it has used all year and is sufficiently vague to keep various options on the table for September and beyond.

That said, there are a few hints that we might be nearing the top for policy rates. Interestingly, the Bank now formally says that policy is restrictive, which seems to be a new addition to the statement – as is the line about policy needing to stay "sufficiently restrictive for sufficiently long". At a pinch, you could argue this is the Bank laying very early groundwork for a pause later in the year, though we're at risk of overanalysing.

Meanwhile the new forecasts, even accounting for the Bank's upside skew that it applies to what its models are churning out, show inflation at (or even a tad below) target in a couple of years' time. Curiously, that's also the case under the assumption that Bank Rate stays unchanged at its new level over the coming months. That said, the Bank's forecasts have been pointing to sub-target inflation for some time now, and policymakers don't appear to be putting a lot of faith in what their models are currently predicting.

So what next? Another hike in September seems likely, but by November we think the news on services inflation and wage growth should be looking a little better. The former has risen in no small part because of higher energy bills, and, according to ONS surveys, the pressure on service sector companies to aggressively raise prices is abating.

Whether or not we get another 25bp hike in November will therefore largely depend on whether services inflation has failed to slow, but our base case for now is that 5.50% in September will mark the peak for Bank Rate. Market pricing of a peak at 5.65% around the turn of the year therefore seems fair – and certainly much more reasonable than it did just a few weeks ago when investors briefly saw peak Bank Rate near 6.5%.

UK markets read the statement on the less hawkish side

Today's MPC statement and accompanying material have seen sterling sell-off around 0.5% and the UK 2-10 year Gilt curve steepen by around 7-8bps, led by declining yields at the short end of the curve. As above, investors seem to have read something in either the statement or the CPI forecasts suggesting that the Bank Rate may not need to be hiked as high as 5.75% after all.

As discussed in our BoE preview, we expect the general direction of travel for EUR/GBP to lie towards the 0.88 area later this year as evidence builds that rates may in fact peak at 5.50%. We still like a higher GBP/USD on the back of the softer dollar story – but that does rely on both US inflation and activity showing a marked deceleration over the coming months. We currently see GBP/USD ending the year just above 1.30.

Gilt price action today comes amid unsettled conditions at the long end of the US Treasury market. A steeper curve does seem to make the most sense, if investors do continue to question whether the Bank Rate makes it to 5.75% and also while the US fiscal situation, plus rising Japanese government bond yields, keep the long end of core bond markets under pressure. Currently, we have a year-end 10-year Gilt target of 3.80% – but that requires a lot of things to go right.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Disclaimer