Bank of England resists pressure to follow the Fed into faster tightening

The Bank of England has stuck to its guns and hiked rates by another 25 basis points, resisting pressure to go faster. The hawkish spin in the policy statement suggests a 50bp hike is entirely possible in August. But the bigger signal here is that, by pricing a terminal rate close to 3.5% next year, markets are overestimating the tightening still to come

Bank of England, in the City of London

Source: Shutterstock

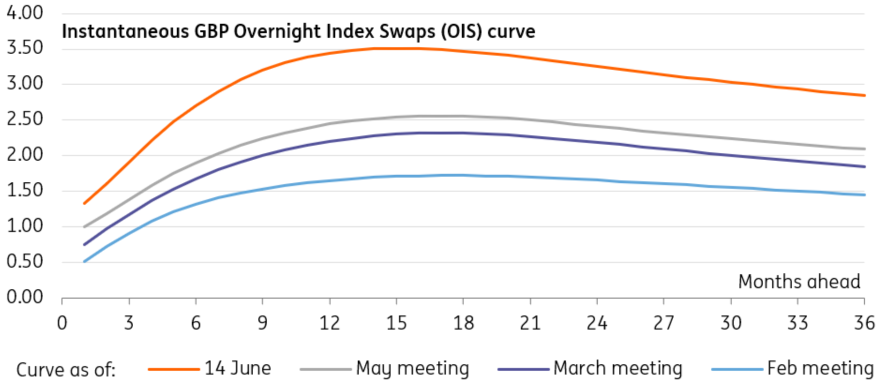
The Bank of England has resisted the temptation to follow the Fed and other global central banks into a more aggressive phase of tightening. Instead the Bank has opted for a fourth consecutive 25bp hike which takes Bank rate up to 1.25%. In fact, despite speculation after Wednesday's Federal Reserve meeting, the vote split was exactly the same as in May, with three out of nine committee members preferring a more aggressive 50bp increase.

But while the hawks failed to win over the rest of the committee, they have succeeded in securing a noticeably more hawkish policy statement. It speaks of UK core inflation being higher than in the US and Europe, and more importantly signals that it will act forcefully if cost pressures become more persistent.

It’s pretty clear that the hawks are nervous about the 8% fall in the pound versus the dollar we've seen so far this quarter. Big picture, this is unlikely to change the inflation story dramatically, but the hawks know this is one of the few things the Bank can influence in an environment of rising dollar input prices.

That means a 50bp move is still entirely possible in August. That’s what markets are pricing, and by then we’re likely to have had another 75bp hike from the Fed, both of which might just be enough to tip the balance narrowly in favour of the hawks.

Markets have been pricing a 3.5% terminal rate over recent days



Source: Macrobond/Bank of England, ING

But today’s decision should, we think, be read as another sign that the Bank isn’t going to tighten nearly as much as markets expect. While the Fed looks poised to take rates well above 3%, it’s harder to see the Bank of England following suit. The most recent BoE forecasts from May, which were premised on a terminal rate of 2.6%, showed inflation well below target at the end of the forecast horizon. We’ll probably get a similar result when the Bank updates its numbers in August.

Meanwhile, even if the latest government support package helps insure against a technical recession, the outlook remains fragile and vulnerable to another leg higher in energy prices later this year. And while the jobs market continues to suffer from a lack of workers, the latest data hinted that shortages are no longer getting worse. We also saw the first whiff of an increase in unemployment following a prolonged downward trend. Wage pressures should cool modestly as the year goes on.

Investors have been pricing a terminal rate above 3.5% in recent days, which seems unlikely to be delivered. We imagine the committee will look to raise rates to the 2% area by the end of this year, which is probably roughly consistent with neutral. Whether that takes the form of a 50bp hike in August and follow-up 25bp in the autumn, or simply three consecutive 25bp moves, will depend more on other central banks and what the pound does between now and the next meeting.

But the bottom line is that markets are still overestimating what's still to come from the Bank of England.

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