Bank of England set for December rate hike despite surprise decision

The Bank of England has defied markets and kept rates on hold, though the statement makes clear a December hike is more likely than not. More importantly, policymakers have offered very little pushback against market expectations for a series of rate rises next year. Nevertheless, we expect at most two rate rises in 2022

Bank of England Governor Andrew Bailey

Source: Shutterstock

Bank of England defies markets and keeps rates on hold

'We will have to act' – but not today.

Despite some hawkish hints over recent weeks from Governor Andrew Bailey, the Bank of England has voted 7-2 to keep interest rates on hold at its November meeting. Its latest statement however leaves little doubt that a rate rise is on the way – and in all likelihood, the committee will vote for a hike in December.

Policymakers have, sensibly we think, opted to wait for more information on how the recent end of the furlough scheme has played out. Early signs suggest there has been no material rise in unemployment (though under-employment may be more noticeable), but the committee will benefit from two additional jobs reports and more official data on furlough data by the time of its pre-Christmas meeting.

There are other uncertainties too, and we think growth momentum will slow noticeably into winter on a mix of tighter fiscal policy and higher inflation. Unsurprisingly, the Bank has lowered its near-term growth forecasts.

That means there is also a chance that policymakers wait until February, when it will next have the opportunity to produce new forecasts and benefit from a scheduled press conference. But purely based on recent comments, we suspect December is more likely. Either way, it's pretty clear that a rate rise is coming.

Market pricing for tightening is overdone

What comes next year however is far less assured. We think markets are wrong to price more than four rate rises by the end of next year, though policymakers have only offered a limited amount of pushback at this latest meeting. Tellingly, the Bank is still forecasting roughly 2% inflation over the medium-term – albeit as policymakers themselves flag, this is based on the unrealistic assumption that wholesale gas prices don't fall back to more normal levels later next year.

> *We expect a December rate rise and at most, two further rate rises next year*

Still, there are undoubtedly warning signs for markets. In the press conference, Governor Bailey hinted that the 'scale' of rate rises expected by investors maybe be misplaced. And the fact that only two members voted for a rate rise at this meeting hints that a rapid tightening cycle could struggle to command sufficient support.

There will inevitably be a debate about whether the seven members who voted to keep rates on hold did so as a temporary pause, or out of broader scepticism that rate rises are needed at all.

With that in mind, we expect a December rate rise and at most, two further rate rises next year (which we're penciling in for May and November 2022). Don't forget that the planned reduction in the size of the balance sheet, when rates reach half a percent, will do some of the heavy lifting.

GBP: Enthusiasm curbed

Failure of the BoE to deliver on the expected 15bp hike today has triggered quite a sharp adjustment in money market rates and the pound. The biggest adjustment seems to have come in the late 2022 pricing for BoE rates, where the December Short-Sterling interest rate contract has rallied 18 ticks. EUR/GBP has risen around 0.9% - close to resistance levels at 0.8530.

Given that it looks like the BoE will probably go ahead and hike in December and that its 'rate protest' against market pricing of the BoE policy cycle was relatively modest, we doubt GBP has to fall too much further. For example, EUR/GBP sellers may return in the 0.8530/60 area.

And assuming that the BoE does hike in December and that UK inflation will keep the BoE poised to act through to next April when UK inflation peaks, we expect EUR/GBP to be pressing and potentially breaking below the 0.8400 level around the turn of the year.

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