Bank of England tightening likely done as it hikes by 25bp

The BoE has kept its options open this month amid financial market turmoil. But assuming the tentatively encouraging trends we've seen in price setting and wage growth numbers continue, we'd expect a pause in May

The Bank of England

Bank of England keeps its options open on future hikes

The Bank of England has increased interest rates by 25 basis points, a move that may well be its last. Bank Rate now stands at 4.25%.

We only get a statement this time around (no press conference), and an initial flick-through shows that it reads as fairly balanced. Growth and employment look stronger, it says, but services inflation - which has been volatile so far this year- is seen as in line with expectations, and nominal wage growth weaker.

In short, the Bank is keeping its options open. Like last month, it has indicated it could hike again if inflation is continuing to show signs of "persistence". Our read of that phrasing is that officials are less beholden to month-to-month swings in the data than perhaps the Federal Reserve/European Central Bank and are trying to take a more top-level look at pricing-setting behaviour. It's this that will determine whether the Bank hikes again in May - and for now we think it won't, though another 25bp move is possible if the inflation data turns more hawkish.

If improvements in broad inflation picture continue, expect a May pause

Indeed, recent trends in inflation have looked more encouraging. The Bank's own survey of businesses suggests price-setting behaviour is becoming less aggressive, while as the BoE acknowledges, wage growth tentatively appears to have peaked on a three-month annualised basis. Services inflation should start to come down in time, with lower gas prices. When asked about recent price hikes by the ONS, service-sector firms more commonly cited energy prices than labour costs as the driver of these changes - and the same should be true in reverse.

Assuming these trends continue then we think a pause in May is likely. That's also partly dependent on banking sector stability and like its peers overseas, the BoE will keep reiterating that it has separate tools that are better suited to maintaining financial stability.

We're also likely to see the committee become more divided. There were no massive fireworks in the vote split on this latest decision - seven members voted for the 25bp hike, and as at the past two meetings, Silvana Tenreyro and Swati Dhingra voted for no change. Both have, however, hinted it might not be long before they consider voting for cuts.

Gilts in the long pause

Gilts, like other bond markets, now have to reflect a new phase of this cycle where central banks are at, or near, their policy rate peak. Two conclusions should ensue. Firstly, stability in policy rates means lower volatility in front-end yields, if the BoE can stick to its message of patience.

Progressively, this volatility will be displaced to the longer end, especially if a resilient economy pushes the inflation premium higher.

The second conclusion is that the yield curve now stands a better chance of re-steepening, as the front-end upside is now limited and as the inflation premium is no longer suppressed by a hiking central bank. We continue to think yields are skewed lower with 10Y headed to 3% by year-end. This is unlikely to be in a straight line however, and we have growing confidence in our call for a steeper curve.

Author

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