Hawkish Bank of England catches markets off-guard

Following some particularly hawkish comments, we now expect a rate hike in May from the Bank of England

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More optimism on growth and wages

The Bank of England has unanimously voted to keep rates on hold today, but it caught markets off-guard with its surprisingly bullish outlook for the economy and interest rates. The main message today is that the key arguments underlying the Bank's decision to hike rates in November – expectations for stronger wage growth and higher, global demand-driven economic growth – are materialising, and in some cases, materialising faster.

The Bank has upgraded its outlook for 2018 growth, in no small part because of the coordinated pick-up we've seen in global growth - the BoE has made noticeable upward revisions to US and Eurozone growth. Policymakers have also said they have "increased confidence" that wage growth will continue to accelerate, citing evidence from Agents that firms are looking to raise pay settlements more quickly this year, with the ability to recruit and raise staff noted as a key driving force. This follows some more encouraging wage growth figures over the past few months, with regular pay rising at a roughly a 3% annualised rate.

However on the latter, we'd still caution that it is still early days, and the last rise should be considered in the context of a particularly weak period for pay this time last year. And whilst the Bank does acknowledge that consumption will remain subdued, we think that the combination of low confidence and rising food/fuel prices could limit economic growth by more than the Bank expects.

A May rate hike now looks likely

But that aside, it's clear the Bank now once again believes market rate hike expectations (roughly one hike per year until 2020) to be too low. The BoE said that rates may need to rise "somewhat earlier" than markets think, and with that in mind we now expect the Bank of England to increase rates at the May meeting. And given the Bank's suggestion that rates will need to rise by a "greater extent", a second hike in November certainly can't be ruled out.

Of course, Brexit could still throw a major curveball into the mix. There has been limited progress so far this year on a transition period, although most parties appreciate a swift deal by the end of March is needed to prevent firms from initiating 'no deal' contingencies. Nor has there been any further clarity on the UK's preferred post-Brexit trade model. This might not be enough to steer the MPC away from a hike in May, but the risk of negotiations heating up from the summer, ahead of October's deadline for a deal, could complicate efforts to increase rates again later this year.

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