

Why the Bank of England won't diverge from the Fed for long

The Bank of England may have got a head-start on the Federal Reserve, but the tone from UK policymakers is still much more cautious. Later this year, however, we think the Bank will be more confident in the inflation outlook and will be content with accelerating the pace of cuts



The Bank of England has kept rates on hold in an 8-1 vote

The BoE is much more cautious than the Fed

What was striking about today's Bank of England decision is how different the messaging was compared to the Federal Reserve yesterday. The Bank has kept rates on hold in an 8-1 vote and the language in the statement makes it abundantly clear that it's not in any hurry to lower rates. By promising a "gradual approach" to rate cuts, the Bank is effectively endorsing quarterly rate cuts of 25 basis points. That suggests the next cut is highly likely in November.

None of this is particularly surprising, but it does beg the question of whether the Bank of England's easing cycle needs to look that different to that of the Federal Reserve. Markets, for some time, have concluded that it will. There are fewer cuts priced this year relative to the US and the terminal rate is some 40-50bp higher too.

It's easy to see why. Not only is the BoE sounding more hawkish, UK services inflation is higher than in the US and eurozone, and at face value, it is going in the wrong direction.

The Bank's hawks worry that corporate price and wage-setting behaviour has permanently shifted in a way that's going to make it perpetually harder to get inflation down on a sustained basis. We're not convinced that's the consensus view on the committee right now – August's decision to cut rates certainly suggests it isn't. But so long as wage growth and services inflation remain sticky, then the committee as a whole seems happy to tread carefully.

We think BoE rate cuts will accelerate beyond November

We're less convinced that the UK's easing cycle will deviate that much from the Fed or others. As the Bank readily concedes, the recent stickiness in service sector inflation is mostly down to volatile categories that hold little relevance for monetary policy decisions. Strip that out, and the picture is slowly looking better.

Meanwhile, the jobs data, though admittedly of dubious quality right now, points to an ongoing cooldown too. The number of payrolled employees appears to be falling now and that will inevitably feed through to wage growth. Companies are consistently lowering their estimates of expected and realised price/wage growth, according to a monthly BoE survey.

We therefore think that Bank of England rate cuts will accelerate after November. Beyond then, we think the Bank will grow more confident in the persistence of inflation and there will be sufficient consensus on the committee to switch to back-to-back rate cuts. Like investors, we expect a cut in November and December, with further cuts in 2025 taking us to 3.25% by the end of next summer.

BoE stays the course on quantitative tightening (QT)

Besides the decision to hold rates unchanged, the BoE also decided to continue reducing the size of its asset portfolio by £100bn over the coming 12 months. Of this amount, £87bn will come from maturing Gilts, and thus relatively little will come from active bond sales. There was some talk that this pace could be increased, but ultimately the Committee seems to prefer maintaining a predictable path going forward. Remember the Bank wants this to be a background process, which allows Bank Rate to remain the active tool for controlling monetary policy.

The impact on market rates will be minimal from the decision to keep the current pace today, bearing in mind that this was also the consensus view. QT will continue to play a role in the term risk premium, but we are likely talking in the range of about 10bp for the 10Y yield over the next year. Regarding liquidity conditions, QT should be less impactful, because the BoE's short-term liquidity facility (STR) has shown significant uptake of late (£44bn) which is helping to mitigate the risks of QT abruptly draining too many reserves from the system.

Authors

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.