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Article

Four scenarios for the Bank of England's May meeting

We expect another 25 basis-point rate hike, but the increasingly cautious language from Bank of England officials and a likely growth downgrade next Thursday suggests that markets are overestimating the amount of tightening for the rest of this year. Our view is that the Bank will hike again in June before pushing the pause button from the summer

Our view is that the Bank of England will hike next Thursday and again in June

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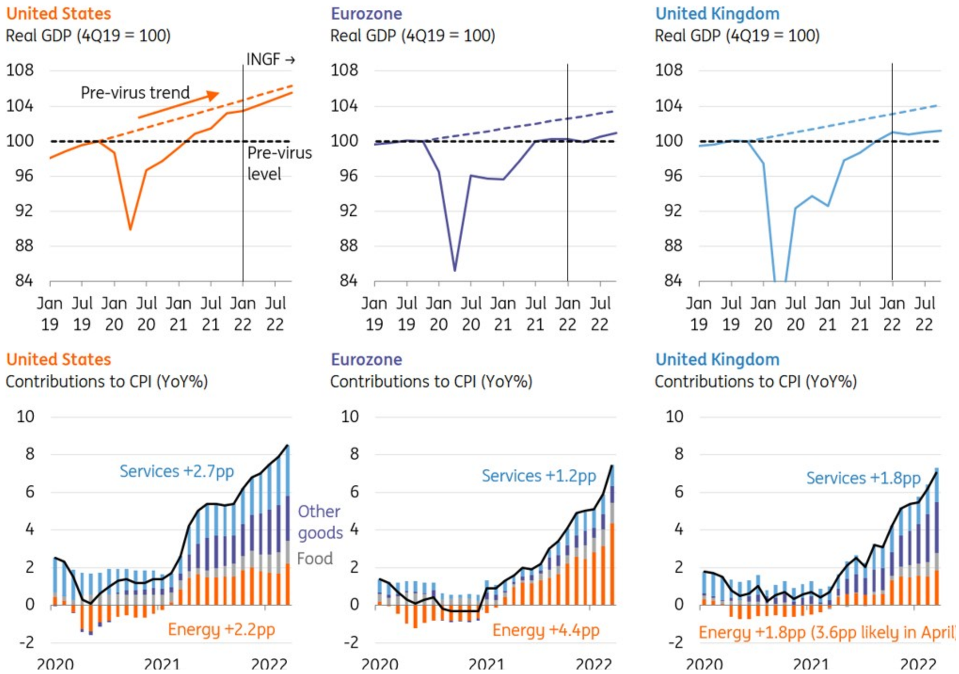
The Bank of England (BoE) sits somewhere between the US Federal Reserve and the European Central Bank when it comes to tightening monetary policy. As BoE Governor Andrew Bailey himself emphasised last week, the UK growth story is much closer to that of Europe, not least because of Britain's reliance on natural gas as a source of electricity. Then again recent UK inflation numbers suggest the wage story has greater similarities to that of the US, where labour shortages are putting ever-increasing pressure on pay – albeit the UK's experience seems less extreme.

And it's that latter driver – coupled with some very hawkish language at the tail-end of last year – that has led markets to price in a tightening cycle that's much closer to that of the Fed than the ECB. Investors expect roughly six more hikes this year.

But that's getting increasingly difficult to see happening. Our own view is that the Bank will hike next Thursday and again in June, but is more likely to then hold fire for the rest of the year.

Expect that more gradual message to be reinforced at the Bank's meeting next Thursday. Here are four things we expect.

How the UK compares to the US and eurozone on growth and inflation



Source: Macrobond, ING

GDP forecasts are from ING's April monthly update

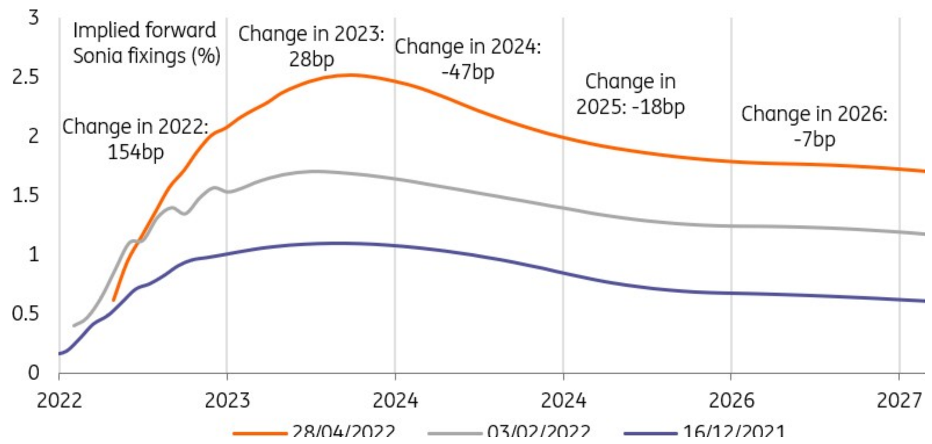
1 Another 25bp rate hike is more likely than a 50bp move

The Bank has hiked three times so far this year and a fourth increase next Thursday looks like a near certainty. The bigger question is whether the BoE opts for another 25 basis-point (bp) move, or whether it follows the Fed and goes for 50bp. At one point last week markets were pricing it as 50:50 either way.

Still, we think 50bp is unlikely. Bailey recently said the Bank is walking a 'narrow path' between growth and inflation, and implied that the Bank was comfortable with taking a more phased approach to tightening. Of course, the BoE is at a slight advantage over some other central banks in that it already has a few hikes under its belt.

And while fellow committee member Catherine Mann didn't close the door to faster tightening in a recent speech, she implied that much would depend on how quickly the consumer story deteriorated. It's still early days, but last week's plunge in consumer confidence and second-consecutive fall in retail sales suggest caution.

The Sonia swap curve is still pricing an unrealistic path for the Bank Rate



Source: Refinitiv, ING

2 New forecasts set to reveal more pronounced growth-inflation trade-off

Even before the war in Ukraine, the Bank was expecting persistently high inflation but a bleak growth outlook. New forecasts due next week are likely to show that this trade-off has only magnified since. Energy prices are higher – and remember that the BoE assumes gas prices stay flat beyond six months in its projections, so the new inflation numbers will ignore the fact that futures prices edge lower beyond next winter.

Meanwhile, markets expect the Bank to hike rates to roughly 2.5% over the next year, which amounts to roughly 100bp more tightening priced in than before the February meeting.

The net result is likely to be an inflation forecast that peaks around 9% in April and stays not far below that throughout 2022, and an economic outlook that features at least one-quarter of negative growth this year. Like February, we also expect the BoE to project a rise in unemployment over the coming years.

If we're right, then this should be read as a hint that market pricing has become too aggressive and investors should prime themselves for fewer rate hikes.

Our four scenarios for the May BoE meeting

Bank of England actions/comments

	Decision	Growth/inflation	Future tightening
1	**No rate hike**	Bank dramatically revises down growth forecasts, expects recession over summer. Wage pressures set to cool	Drops guidance that further 'modest' rate hikes are likely
2	**25bp rate hike** 6-3 vote in favour	More committee members join Cunliffe in voting against another hike as concerns about cost of living/growth build	Forecasts clearly imply that, based on market rate hike pricing, inflation will undershoot
3 (ING base case)	**25bp rate hike** 8-1 vote in favour	Inflation revised up but negative economic growth now expected. Unemployment set to gradually rise	Reiterates more 'modest' hikes coming and risks either way. Bank opts against starting active gilt sales
4	**50bp rate hike**	Price pressures broadening out and wage growth too quickly. Justifies faster front-loaded tightening	Little/no pushback against market pricing of six more hikes this year. Active gilt sales to begin

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3 Watch out for signs of the committee becoming more divided

Ever since the Bank began hiking late last year, we've felt that the committee would probably become more divided on the need for further tightening as the Bank rate ratcheted higher.

That theory looked severely misplaced after four out of nine committee members voted for a 50bp hike back in February. But since then, we saw one official – Jon Cunliffe – vote for no change in rates at the March meeting, explaining subsequently that he was less fazed than others by the rise in consumer inflation expectations.

We suspect next week's vote split will be 8-1 again in favour of a hike, but if the dissent becomes more widespread then that would be another hint to markets that the rate hike cycle could be nearing a pause.

4 Bank to offer new guidance on QT but stop short of starting gilt sales

The Bank kick-started its quantitative tightening (QT) process back in February, and has previously signalled that this could be accelerated by actively selling government bonds back into the market. We recently argued that the rise in market volatility suggests now is not an opportune moment for the Bank to start doing this. And instead, we simply expect to get some further detail on how such a policy could work in practice, not least the mechanics of how the sales might be conducted.

Assuming market conditions improve, there's still a fair chance the Bank will start selling bonds within nine to 12 months. Without sales, the BoE's balance sheet is going to decline at a very slow pace.

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