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Article

## Timing the Bank of England re-pricing

Markets are getting ahead of themselves on Bank of England tightening, and we expect some subtle warnings from the November policy meeting. That may not be enough to turn the near-term bullish GBP trend. However, we do expect a reappraisal of the BoE outlook in rates markets and look for a re-steepening of the curve



The Bank of England

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### Markets are banking on a rapid tightening cycle from the Bank of England

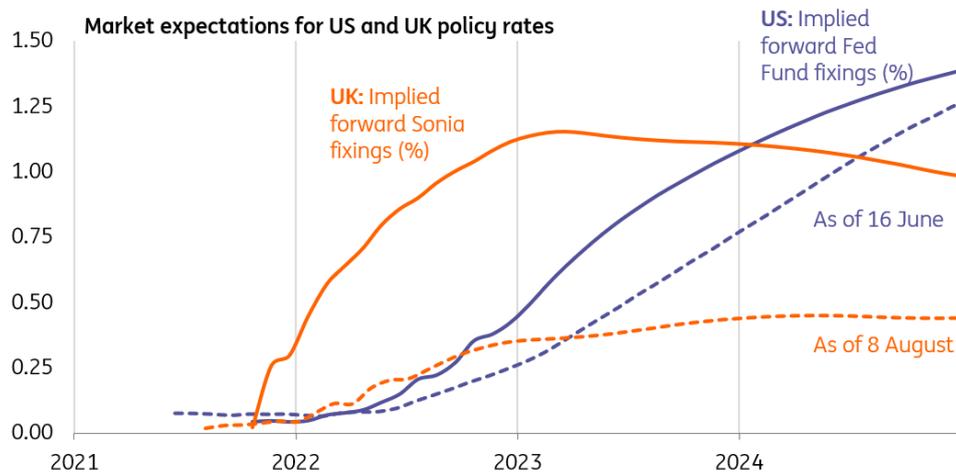
If financial markets are right, UK interest rates will have hit 1% by next summer. That would take the Bank rate to the highest level since before the global financial crisis. And that's on top of the Bank of England's planned move to shrink its balance sheet when rates hit 0.5%.

Economists are fairly united now that these market expectations are overdone. Unusually this pricing implies that the BoE will need to do more than the Fed to tackle rising inflation – something we think isn't justified. [Our own view](#) is that, beyond an initial rate hike in November, the subsequent tightening process is likely to be much more gradual than investors are currently pricing.

But picking out the catalyst for a rethink in financial markets is less straightforward. It may take

some time for a correction to materialise.

Investors are pricing in a lot more from the Bank of England than the Fed



Source: Refinitiv, ING Rates Strategy Team

Certainly, it seems that there's little appetite among Bank of England officials to lean against current market pricing. If anything they have doubled down on concerns about inflation risks. Governor Andrew Bailey said last weekend that policymakers will 'have to act'.

True, we have had some moderate pushback from some of the more dovish committee members. Silvana Tenreyro, who is perhaps the most dovish voter, said a rate hike would be 'self-defeating'. But policymakers have also hinted that the steeper yield curve is doing the Bank's job for it, in effect providing it with the inflation hedge it's looking for. That was essentially the argument put forward by newly-appointed MPC member Catherine Mann a few days ago.

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### If policymakers project less inflation, it's an implicit hint market pricing's gone too far

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We'd also note that if the Governor votes for a hike, then much of the 'core' of the committee will likely follow. We wouldn't be surprised therefore to see six or seven MPC members (out of nine) vote for the rise this November.

Still, this should still be a warning sign for markets. The first rate hike is likely to be smaller than usual – a 15bp move compared to the more usual 25bp. And if that can't command a unanimous vote, then it's tricky to see further steps in a rapid tightening cycle gathering sufficient support.

There may be further hints of pushback contained within the new set of November forecasts. Remember the Bank of England plugs the latest market yield curve directly into its models. In the last set of projections from August, the Bank reckoned inflation would be on target in the medium-term, based on the 40bp worth of tightening by 2024 that was priced by markets at the time.

The latest, steeper yield curve would imply a downgrade to that inflation forecast, barring any offsetting, optimistic changes in assumptions elsewhere. We could see a bit of that – we may for instance witness upgrades to wage growth linked to the recent shortages in the labour

market. But we still wouldn't be surprised if policymakers project inflation to be a little below target in a couple of years' time – an implicit hint that market pricing has gone too far.

## GBP Rates: Cooler heads should prevail

Time will tell whether any of this will prompt a rethink in financial markets. Much has been said of the yield curve re-pricing of BoE rate hikes in October but comments often overstate the market's confidence in that tightening path.

Granted, there has been only limited retracement so far when it comes to hikes priced within the next 12 months, towards something we think is a more realistic trajectory for the Bank Rate, but one only needs to look at longer rates to show what the market thinks of this. For a start, the same curve implies rate cuts in the subsequent years, adding up to roughly 25bp between 2023 and 2025. If there was any degree of conviction that the 2021-22 hikes are sustainable, this isn't how the curve would look

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1%

Market expectations for Bank rate  
next summer

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In longer maturities, the near-inversion of various segments, most prominently GBP 10s30s, is a sure sign that markets do not assign a high probability to 1% being reached in the Bank Rates. Policymakers have said that it could actively sell gilts to private investors after that point, and longer rates aren't consistent with that. In fact, we don't even think they reflect the possibility of balance sheet reduction after February 2020, when the Bank Rate should reach 0.5% according to market pricing.

The path for GBP rates most consistent with our macro view is a re-steepening of the curve due to lower rate hike discount at the front-end, but also reflecting more accurately the shortfall in gilt demand stemming from the BoE balance sheet reduction.

## GBP FX: Scope for a temporary set-back?

On a broad, trade-weighted basis GBP is now at the highest levels seen since the Brexit vote in June 2016. Driving this has undoubtedly been the story that the BoE falls into the camp of central banks prepared to react to the inflation shock.

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**We doubt this will turn the near term bullish trend for GBP**

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A re-pricing of the BoE cycle on the back of a very split vote to hike on 4th November or on some form of rate protest in the BoE's three year CPI profile (2024 forecast below 2%) could trigger a knee-jerk sell-off in the pound. The day risk volatility priced in the FX options market suggests that sell-off could drive EUR/GBP some 40 pips higher on the day.

Yet we doubt this will turn the near term bullish trend for GBP. The fact that the BoE has set its tightening stall out (like fellow G10 central bankers in Norway and New Zealand) suggests it is very hard to play the top in UK rates and the pound. Energy prices look set to stay supported this winter amidst low inventories and the lagged effect of the energy price rise look likely to