MARKET COMMENTARY

Bank of England: Less dovish than expected

Christoph Siepmann

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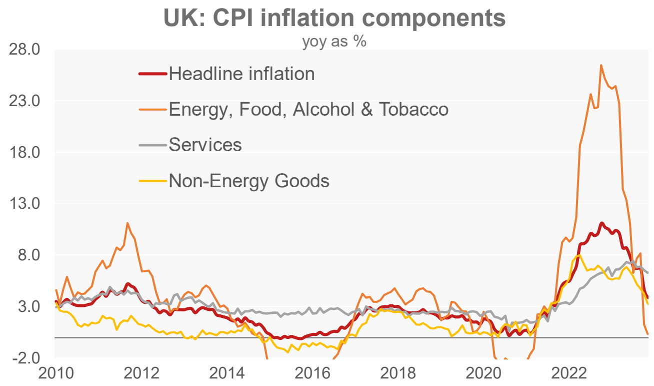
- **As widely expected, the Bank of England (BoE) left its monetary policy unchanged today. However, two Monetary Policy Committee (MPC) members still voted for a 25 bps hike, one for 25 bps cut, while the other six decided to keep the rate. This compares with a more coherent consensus forecast of one hiking but eight maintaining votes.**
- **While the BoE agrees that inflation will likely fall to the 2% target as early as in Q2 2024, it expects a re-increase thereafter with a rate of 2¾% by the end of this year. Accordingly, Governor Bailey insisted that the MPC would need more evidence that "*inflation is set to fall all the way to the 2% target, and stay there, before we can lower interest rates*".**
- **In its forward guidance, the BoE changed to a softer tone mainly cutting out its tightening bias.**
- **We expect the BoE to start cutting rates in June (May has become less likely today in our view) by 25 bps and a total of 100 bps by the end of 2024. Markets have not moved much after today's meeting.**

UK headline inflation had surprised on the downside at the end of last year, falling from 6.7% yoy in September to 4.6% yoy in November and further to around 4% yoy for the rest of 2023. This development was unforeseen by the BoE which still projected an inflation average of 4.6% in Q4 2023. The main reason for the strong disinflation lies with energy prices which currently decrease by a rate of around -17% yoy. By contrast, food prices still advanced by about 8% yoy in December. Moreover, core inflation was as high as at 5.1% yoy in December. The BoE shares the view that inflation will reach 2% in Q2 (the inflation target) which we forecast for April 2024. However it insists, that inflation will reaccelerate thereafter and end the year at about 2.7% yoy in its most likely projection and remains above target until end 2026 according to the model prediction. The fluctuations are mainly due to the energy component. Oil and gas prices have declined materially since November, but their negative contribution will recede substantially from mid-year. In addition, the Government could go ahead with the planned increase in fuel duty in March and April, which would push up CPI inflation by 0.2 pp. Uncertainties remain high e.g. given the recent disruptions to shipping in the Red Sea.

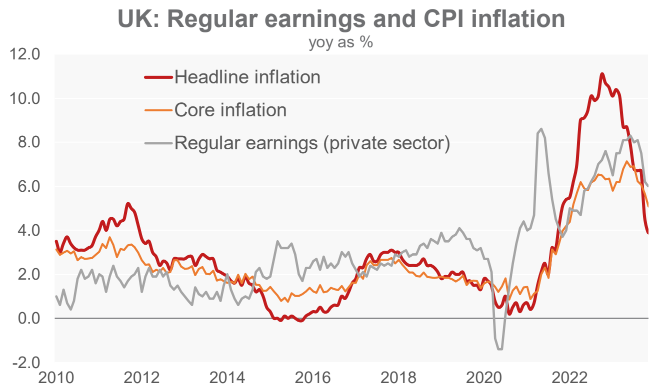
Given the expected lower disinflationary contribution from the energy component, the BoE sees above target inflation to reflect domestic inflationary pressures. GDP growth is projected to pick up gradually during the forecast period from 0.3% in 2024 to 0.6% in 2025 (broadly consistent with our view in 2024 but much more pessimistic in 2025). This is largely caused by assuming key rates cuts in line with current market expectations to 4.2% by end 2024 and 3.4% by end 2025. In the alternative scenario, in which the BoE keeps its current policy stance of 5.25%, the UK would remain in recession through-out the forecast horizon. The BoE also sees wage growth to stay an inflation driver. Although annual private sector regular average weekly earnings (AWE) growth declined to 6.5% in the three months to November (1pp below the BoE expectation) and is expected to soften further, the level remains elevated at 4% in Q4 2024.A level of about 3% is considered compatible with inflation at target.

Against this backdrop, the BoE's forward guidance remained a bit more reluctant compared to US Fed or the ECB. The BoE changed to a softer tone by mainly cutting out its tightening bias. Although it kept the phrase that policy needs "to be restrictive for an extended period of time" it replaced "further tightening […] would be required if there were evidence of more persistent inflationary pressures" by "the Committee will keep under review for how long Bank Rate should be maintained at its current level".

Even if the BoE sees its inflation target not yet reached and secured, the economy does not need such a tight policy anymore. According to the BoE model, maintaining the current key rate would bring down inflation to around 2% over the short term, which then proves somewhat sticky but diminishes to 1.2% yoy by Q2 2026.This would imply an overtightening in the longer run and come at the cost of a prolonged recession. Thus, we expect the BoE to start cutting rates in June (May has become less likely today in our view) by 25 bps and a total of 100 bps by the end of 2024 which is broadly in line with market views. We see inflation at 2.4% and 2.1% in 2024 resp.2025.



Source: Datastream, GenAM calculations



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