MARKET COMMENTARY

BoE: First major central bank to start hiking cycle

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- **The Bank of England (BoE) is more likely than not to hike its Bank Rate tomorrow by 15 bps to 0.25%. Otherwise, we see the hike on December 14. We expect a second hike by 25 bps in February and a third one to 0.75% late next year.**
- **This path is considerably more cautious than markets currently price in with a Bank Rate at 1.25% before the end of 2022. Accordingly, we see a (at least implied) push-back to market rates which could come from the MPC's forward guidance, voting results or inflation outlook.**
- **If the BoE softens market expectations tomorrow as expected, the rise in short-dated yields will also be dampened – but we do not forecast a lasting impact on the long end.**
- **We will discuss the outlook in more depth in a Focal Point to be published over the next days.**

We expect the BOE's Monetary Policy Committee to hike Bank Rate by 15 bps tomorrow. However, we prefer this date to the next meeting on December 14 only by a small margin. The main arguments for tomorrow are the possibility to explain the decision in a context of a regularly updated macro projection and a press conference. The December meeting would give more precise insights about the impact of the end of the furlough scheme (which ended on September 30, but data have a considerable delay) on the labour markets.

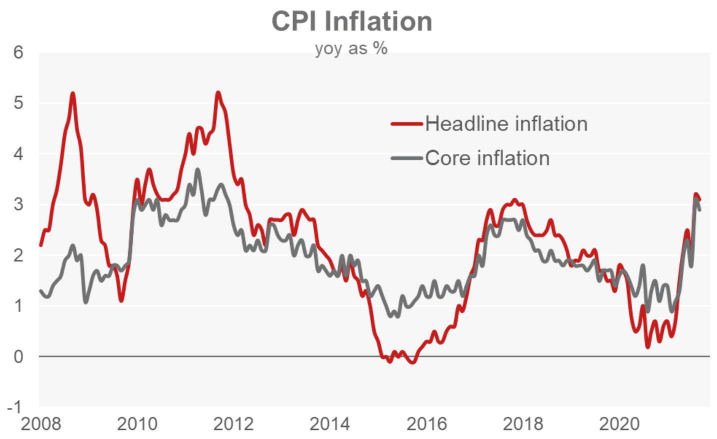
In any case, the BoE is in a difficult situation. It needs to weigh the post-Covid demand outlook (among continued risks from high infections rates) against the inflation-driving bottlenecks in domestic and international supply chains, labour shortages in some sectors (transport, and the Brexit effects) and the energy price increases. The BoE has an explicit inflation target of 2%, latest realised inflation was 3.1% yoy. Moreover, inflation is likely to rise substantially further, already from October on due to energy prices. Inflation expectations already have spiked up according to a recent YouGov/Citi survey. Annual growth in total pay was 7.2% and regular pay was 6.0% in the three months to August 2021; slightly lower than before. However, the data are substantially affected by base effects as the furlough schemes covered only 80% of the regular pay.

The post-Covid demand on the one hand and the supply-side driven inflation on the other put the BoE into a dilemma. By fighting inflation too strongly, it risks damaging growth too much. We therefore expect the BoE to embark on a cautious approach. It will signal its readiness to bring inflation down, but hiking Bank Rate strongly would restrain demand on top of the already stagflationary effects from the supply side/energy bottlenecks. Thus, we consider market expectation of reaching a Bank Rate of 1.25% before the end of 2022 as too ambitious. The new chief economist Huw Pill also expects inflation to come substantially down in the second half of 2022. If this thinking will be maintained the BoE will at least implicitly signal that the current market path is overdone. Those signals may come from the forward guidance, the inflation outlook but also by voting preferences. We expect Bank Rate to not exceed 0.75% by end 2022.

If the BoE raises its key rate tomorrow, it could consequently also end its QE programme. Again, we think that this is slightly more likely than not. However, in the past the BoE made clear that it would not exclude a first rate hike while the programme was still running.

Should the BoE dampen market expectations as explained above, the rise in yields at the short end is also likely to lose momentum. A similar pattern has already emerged at the beginning of the week after the Reserve Bank of Australia dropped the yield target for the short end, but dampened expectations for future key rate hikes. Amid our more cautious key rate forecasts we see 2-year UK yields to rise to 0.85% on a 1-year horizon (after surging by 40 bps to 0.65% since end of August).

By contrast, elevated inflation expectations well above the BoE's target are seen to pave the way to a further increase in long-dated yields. The looming end of the BoE's Gilt purchase programme will be an important technical factor fostering higher long-dated yields. This applies even more as another hike to 0.5% implies the quasi-automatic beginning of passive Quantitative Tightening.



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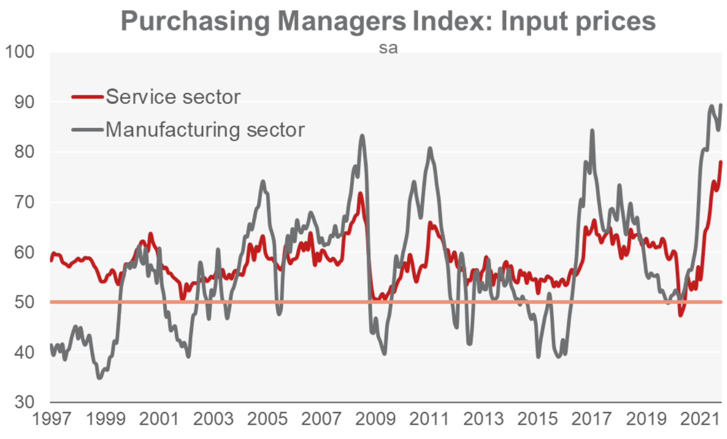

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