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Hawkish BoE Adds Fuel to Hike Bets, ECB Opts for Neutrality

- The European Central Bank (ECB) and the Bank of England (BoE) left their key policy rates unchanged at their respective policy announcements this morning, as was universally expected.
- We believe the ECB is in for a long hold at 2%, with higher odds of a hike than a rate cut, although this would require a longer period of even higher energy prices. As things stand, we also anticipate that the BoE will stand pat through the remainder of 2026. Given the weak U.K. economic backdrop we think the bar for a hike is currently elevated, though a continued rise in global energy and food prices with a tight follow through in inflation expectations could justify tighter policy.
- The BoE opening the door to hikes triggered steep losses in U.K. gilts and a significant rise in hike bets which now sit at about 60bps, a 100bps+ flip from the ~50bps in cuts expected at the end of February. Meanwhile, the ECB's neutral, data-dependent stance pulled German yields lower versus pre-decision, but 2026 hike bets rise to ~60bps from ~53bps in line with the move in global short-term yields on the day.
- The BoE overhauled its guidance in today's statement, to one that clearly proposes that hikes are a possibility, saying that "it stands ready to act as necessary to ensure that CPI inflation remains on track to meet the 2% target in the medium term." The energy prices shock would result in headline inflation between 3% and 3.5% over the next couple of quarters, a large shift from the convergence to 2.1% and 2.0% in 2Q26 and 3Q26 as per the February Monetary Policy Report (MPR).
- Alongside today's announcement, the ECB updated its macroeconomic projections, partially incorporating the run-up in oil and natural gas prices of recent weeks. The bank's staff new forecasts have inflation averaging 2.6% and 2.0% this year and next, respectively, up from the December round's 1.9% and 1.8%, in that order, given higher energy prices.

The European Central Bank (ECB) and the Bank of England (BoE) left their key policy rates unchanged at their respective policy announcements this morning, as was universally expected by economists polled by Bloomberg, with zero basis points (bps) priced in (up or down) by traders as per overnight indexed swaps. While an ECB rate hold at this month's meeting has been a longstanding view for the past three months, economists and markets favoured a 25bps reduction by the BoE during most of February, before sharply withdrawing these bets since the breakout of the conflict in the Middle East.

We believe the ECB is in for a long hold at 2%, with higher odds of a hike than a rate cut, although this would require a longer period of even higher energy prices—as presented in the ECB's adverse or severe scenarios (more below). While prior to the conflict in the Middle East we had penciled in two BoE rate cuts this year, recent developments in energy markets lead us to expect no more easing this year, as things stand. Given the weak U.K. economic backdrop we think the bar for a hike is currently elevated, though a continued rise in global energy and food prices with a tight follow through in inflation expectations could justify tighter policy.

The banks' decisions had markedly different effects on their respective country's markets, with the BoE opening the door to hikes triggering steep losses in U.K. gilts (with 2s up ~25bps and 10s up ~10bps on the day) and a significant rise in hike bets which now sit at about 60bps, a 100bps+ flip from the ~50bps in cuts expected at the end of February. Meanwhile, the ECB's neutral, data-dependent stance pulled German yields lower by 2–3bps versus pre-decision, with 2s and 10s currently sitting ~10bps and ~2bps higher on the day with their price action tracking a global easing in elevated yields, while 2026 hike

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bets rise to ~60bps from ~53bps in line with the move in short-term yields. The GBP and EUR 0.8% and 0.5% stronger on the session, among the best major currencies in the case of the GBP and in the middle of the pack for the EUR amid broad dollar weakness.

With the ECB and BoE delivering on expectations, the focus was on the banks' statements for guidance on how they intend to respond to the emergence of important energy inflation pressures and their balance with the adverse economic impact of higher energy prices, considering the Eurozone and the U.K.'s great dependence (particularly the former) on foreign energy. From the ECB, we also heard from President Lagarde at her post-decision press conference and the bank's staff also published fresh macroeconomic projections.

BOE HIKES ARE AN OPTION

The BoE overhauled its guidance in today's statement, to one that clearly proposes that hikes are a possibility, saying that "it stands ready to act as necessary to ensure that CPI inflation remains on track to meet the 2% target in the medium term." The BoE noted that while prior to the conflict there had been continued disinflation (which would have allowed another cut today or at one of the upcoming meetings), the new shock will result in higher inflation in the near term, with second-round (wages and price-setting) effects risks being "greater the longer higher energy prices persist."

The minutes to the meeting reinforced the hawkish tone of the decision, saying "a larger or more protracted shock, which risked greater second-round effects in wage and price setting, would require a more restrictive policy stance," but "conversely, policy would need to be less restrictive if the shock was very short-lived, or if there were to be a larger opening up of slack in the economy."

On that note, Governor Bailey highlighted in the bank's minutes that "the recent experience of high inflation may also make households and businesses more sensitive to a new inflationary shock," though he conceded that U.K. households are in worse spending standing than in 2022. The BoE's new forward guidance suggests that it could be a long time before we see another rate cut in the U.K. The Monetary Policy Committee's (MPC) vote breakdown of a unanimous 9–0 hold-cut vote also took markets and economists, which expected a 7–2 split, by surprise.

The BoE is not due for a forecast update until its May meeting, but the monetary policy summary and minutes accompanying the decision highlight that the energy prices shock would result in headline inflation between 3% and 3.5% over the next couple of quarters, a large shift from the convergence to 2.1% and 2.0% in 2Q26 and 3Q26 as per the February Monetary Policy Report (MPR). As for forecasts beyond this point, it remains too early to determine but the BoE should have more information by its April 30th meeting alongside new forecasts in the MPR.

Given the lag between energy prices in financial markets and utility bills for U.K. households (mainly due to the one-quarter-lagged Ofgem price cap reset), the BoE may not have full clarity on the influence of higher internationally-traded energy prices on final prices to consumers until several months from now—and even longer on how higher energy bills and fuel prices influence the prices of core categories or wage demands. Subsidized energy bills, as scheduled from April onwards, should dampen this shock but the rising fiscal cost of these subsidies given higher global energy prices risks a change of heart by the Starmer government or less extensive breaks as soon as the July–October quarter. On the other hand, U.K. households will not be protected from higher petrol costs nor higher food prices due to shortages in fertilizer supplies, which would be directly felt as soon as the March/April CPI releases.

Meanwhile, the U.K. economic and labour market situation would have warranted a rate cut at today's decision, with data released a few hours pre-BoE announcement showing that the country only added 20k payrolled employees in February. Although this was above forecasts of a 10k decline, U.K. payrolls have fallen by a net ~115k positions since October 2024, remaining a good deal beyond the pre- or post-Covid trends. At 5.2%, the country's unemployment rate as of January is just shy of the 5.3% Covid-19 peak, almost a full percentage point above its January 2025 level.

Assuming that energy prices normalise in the second half of the year (albeit at a higher level versus pre-conflict, economic conditions would be supportive of a couple of 25bps cuts by the BoE in each of 3Q and 4Q to end the year at a 3.25% terminal rate. However, today's BoE hawkishness and growing risks of a longer-lasting effect on global energy prices amid attacks on Middle Eastern energy infrastructure are pointing to no more rate cuts this year, with the bias towards cuts or hikes depending on the evolution of the conflict and commodity prices in the coming weeks and months.

ECB STICKS TO NEUTRALITY, BUT ADVERSE SCENARIOS COULD WARRANT HIKES

In its opening statement, the ECB highlighted that "the war in the Middle East has made the outlook significantly more uncertain, creating upside risks for inflation and downside risks for economic growth," and "its medium-term implications will depend both on the intensity and

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duration of the conflict and on how energy prices affect consumer prices and the economy.” Sticking to a data dependent approach, the ECB also maintained a neutral bias saying that this approach “will help it set monetary policy as appropriate.” ECB President Lagarde stuck to a neutral tone at his post-decision press conference, saying that the bank is “well positioned” in the face of greater uncertainty, while stressing that the current situation is not a repeat of the 2022 inflation surge (when supply chain issues and a strong post-Covid rebound piled on inflationary pressures).

Alongside today’s announcement, the ECB updated its macroeconomic projections, partially incorporating the run-up in oil and natural gas prices of recent weeks. The bank’s staff new forecasts have inflation averaging 2.6% and 2.0% this year and next, respectively, up from the December round’s 1.9% and 1.8%, in that order, given higher energy prices. Note that the forecast path, with only a 0.2ppts revision higher to the 2027 inflation projection suggests the ECB is incorporating a normalization of energy prices—a longer-lasting effect would result in a longer overshoot of the inflation goal. Since end-February, the regional Dutch natural gas benchmark has risen by around 75%, to €55/MWh (Wednesday’s close, or €61/MWh at writing), far below the €200/MWh+ it averaged at its peak in summer 2022. Core inflation is now seen at 2.3% in 2026 and 2.2% in 2027, up from 2.2% and 1.9% in December, reflecting the pass-through of higher energy and food prices, and with the latter’s greater upside revisions possibly incorporating a lagged (and larger) second-round effect via wages.

On the GDP front, the ECB clipped its 2026 and 2027 growth forecasts to 0.9% (from 1.2%) and 1.3% (from 1.4%), as higher electricity and fuel prices dampen industrial output and discretionary household spending, with the conflict also dampening consumer and business sentiment. According to the ECB, these factors will be offset by low unemployment, strong private balance sheets, and fiscal outlays in defence and infrastructure.

Aside from its central scenario, the ECB published alternative paths for the bloc’s economy based on how long the conflict and elevated energy prices last; in contrast to its baseline projection that only includes the latest energy futures curves. Note that neither of these scenarios incorporate fiscal or monetary policy responses that could lessen the inflationary or economic impacts. In an adverse scenario, the ECB assumes a 40% drop in oil and gas transit through Hormuz over 2Q (already a reality) with volumes and prices normalising from 4Q26. In a severe scenario, the ECB assumes 60% decline in shipments and a slower normalisation from 1Q27 that also assumes the destruction of energy infrastructure. In the adverse scenario headline/core inflation would average 3.5/2.4% in 2026 and 2.1/2.7% in 2027, while in the severe scenario it would average 4.4/2.6% in 2026 and 4.8/3.9% in 2027. In the severe scenario, a hike would certainly be in play. As for GDP growth, growth in the adverse/severe scenarios are seen at 0.6/0.4% 2026 and 1.2/0.9% in 2027.

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