

FLASH REPORT

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- The Bank of England raised its policy rate 50bps to 4.00% today, as expected. While the 7-2 vote split would suggest a hawkish decision, the wording changes to the statement, the minutes, and comments on mispriced longer-term rate expectations in markets give the overall communications a dovish tinge that tee up a final 25bps hike in March.
- As widely expected, the ECB lifted its three key monetary policy rates by 50bps today and reaffirmed its intention to deploy another 50bps increase in March. Yet, the statement and Lagarde's presser left markets wanting with hazy guidance for the May meeting—in a quick softening of December's ultra-hawkish tone.

BOE NEARS END OF HIKING CYCLE

The Bank of England raised its policy rate 50bps to 4.00% today, as expected by us and the median of economists surveyed. This was also roughly in line with swaps pricing that sat at ~45bps this morning, coinciding with 10 out of 46 of those polled by Bloomberg calling for a 25bps increase.

While the 7-2 vote split across a 50bps increase versus no hike would suggest a hawkish tilt to the decision, the wording changes to the statement, the minutes, and comments on mispriced longer-term rate expectations in markets give the overall communications a dovish tinge.

Today's decision has teed up a final 25bps hike in March justified by tight labour markets and persistent inflationary pressures, as well as continued apprehension among central bankers in the fight against inflation. Given that the BoE expects services inflation to continue rising, the bar will likely be met for further tightening next month as suggested by "if there were to be evidence of more persistent pressures."

That same sentence introduces a slight chance of a hold next month, however, if labour markets and/or wages growth weaken in January and February data (out on in mid-February and mid-March) while headline inflation maintains its expected downtrend. The BoE has included conditionality for a March hike along the same lines as the BoC in December—which nevertheless was followed by a 25bps increase last week.

Our forecast for the BoE to conclude its hiking cycle with a 25bps increase to 4.25% in March is therefore left intact, as is our expectation for 100bps in cuts over the course of 2024. Throughout, the UK economy is set to remain weak amid the cost-of-living crisis and high interest rates, as well as weak consumer and business sentiment, hobbled by strikes and the lingering impact of Brexit.

Market reaction: head-faked by vote split, unwound on statement tone

The GBP had already significantly underperformed its peers this morning ahead of the announcement, erasing the gains made on the Fed's announcement yesterday, as traders braced for a dovish decision.

The pound chopped higher on the 7-2 vote split to erase its losses on the day, before falling equally sharply, and then some, to an intraday low of 1.2240. The GBP is about 0.3% weaker against the dollar from pre-statement levels at the time of writing for a daily loss of 0.7% as the cross meekly fights to hold onto the 1.23 figure that has roughly supported it over the past two weeks; but trading today at its weakest level since mid-Jan is not constructive. Cable's performance stands in contrast to an almost equally battered EUR

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on the day after Lagarde checked her hawkishness at the ECB post-decision presser—which has in fact resulted in a net 0.3% gain in GBPEUR from pre-BoE levels.

As for gilts, depressed yields also jumped initially on the statement but fell further after the initial choppiness, with 10s down ~25bps (vs -12bps pre-BoE) and 2s down 15-20bps (vs -8bps pre-BoE) on the day. US and German 10s are down ~5 and ~25bps, respectively, today.

Meanwhile, the market-implied terminal rate fell 8bps to 4.27% currently (5bps of that drop was pre-decision), reflecting that markets are leaning towards only one final 25bps hike at the end of Q1.

Vote split: no takers for 25bps

The 7-2 vote split came as somewhat of a surprise as we had expected one official (if not two) to vote in favour of a 25bps hike. Instead, the five internal members of the Committee voted as a block for a 50bps increase, joined by Haskel and Mann (who shifted to 50bps from her prior call for 75bps), while Dhingra and Tenreiro stuck to a no-hike vote.

At face value, that would guarantee at least a 25bps hike at the March meeting, and for outsiders it would suggest there is still a risk of another 50bps. That is not the case, however. The internal cadre of the BoE may have wanted to show a united front, coalescing around a 50bps increase while inflationary pressures and tight labour markets warranted another large move, but the bank has now increased its policy rate by 390bps since December 2021 and they are not at a point that warrants continued half-point increases.

Statement changes: tee up end of hikes

The minutes from the meeting reflect a sense that officials believe inflation is due to fall sharply after beginning “to edge back” thanks to developments in energy and goods prices. The statement dropped “forceful” and “forcefully” from its previous iteration in reference to the response needed and which may be needed.

Instead, the decision now notes that “if there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required”. Bailey highlighted in the press conference that these language changes were “quite deliberate.” There are two important dovish components to consider here: first, that the bank is moving away from large hikes, and second, that the bank needs to see *evidence of more persistent pressures* to hike again.

This implies optionality in hiking as a flattening of wages growth or services inflation may (under a complete set of circumstances) by itself be enough to warrant a rate hold at the next meeting. Now, this is not our call as there are still tailwinds in services inflation and labour markets that will tilt the bank towards a final hike in March, but watch wages (and negotiations), employment, and services inflation in the next few weeks for a chance of the BoE closing its tightening cycle at a round 4%.

Updated forecasts: lower near-term inflation, shallower recession, market rates pricing still off

Updated forecasts from the BoE show a more benign outlook on the growth and inflation front fronts. With a less negative cost-of-living crisis as well as a flatter rates profile, UK output is projected to be 1.1% lower from peak at its trough in Q2-2024 compared to a 1.7% peak-to-trough decline in the November scenario.

The steep drop in UK energy prices since the BoE’s past forecast round is largely behind the 1.27ppts decline in the bank’s projection for headline inflation at end-2023—now sitting at 4.23% y/y vs 5.50% in the previous *Monetary Policy Report*. The Q4-2024 inflation projection was, however, lifted a touch higher (to 2.06% from 1.82%). This is mostly a result of the BoE incorporating a lower interest path this time around as markets corrected more of the mini-budget spike in short-term rates in the interim—with the rate path imposed in this forecast round peaking at 4.46% in contrast to 5.17% in November.

Beyond Q4-2024, inflation falls below the 2% target to as low as 1% at the end of the forecasting exercise in Q1-2026, with the BoE (and Bailey) in his presser again highlighting that the rate path implied by swaps that still saw a 3.30% Bank rate in early-2026 would result in a large undershooting of inflation. There is an important overshooting in market pricing of the BoE that must be corrected.

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ECB MEETS EXPECTATIONS, BUT SOFTENS HAWKISH STANCE

As widely expected, the ECB lifted its three key monetary policy rates by 50bps today, namely the deposit facility rate to 2.50%, and reaffirmed its intention to deploy another 50bps increase in March. Yet, the statement and Lagarde's presser left markets wanting as guidance for the May meeting is hazy and some may have expected comments regarding the bank's intention to accelerate QT in the third quarter.

Today's announcement was a significantly less eventful affair than the December decision that was accompanied by a new set of forecasts and Lagarde establishing herself as the biggest hawk among top central bank officials. Already, a few weeks later, she has had to soften her stance—while remaining the top G10 hawk—given the more favourable energy prices backdrop that has quickly rendered the Q4 projections as somewhat stale. Lagarde may have also been thrown a curveball by the lack of German inflation data for January, whose release was pushed to next week instead of this past Tuesday due to a “technical data processing problem”; it's tough to make a call on what has changed on the inflation front without the latest data from the bloc's largest economy.

Market reaction: cin cin

With neither the ECB nor Lagarde wanting to pre-empt the May decision, and thus putting the odds in favour of a 25bps increase, the EUR weakened over a full cent from pre-decision levels with pronounced declines in European yields across the curve (Putin's bellicosity also probably didn't help). Market pricing for the bank's terminal rate is lower by about 15bps and contracts are now seeing a peak deposit rate of 3.50% in June equivalent to hikes of 50, 25, and 25 in March, May, and June, respectively.

Given the lack of comments around an accelerated QT pace in Q3 and the softer policy outlook from the ECB today, Italian yields are sharply lower across the curve. Yields on 2-yr German bonds are down 15-20bps compared to 25-30bps in Italy. In the 10-yr space, BTP yields are down 40bps compared to 20bps in Bunds for an 20bps decline in the spread between these two to about 180bps, correcting an important share of the widening seen since mid-month.

Traders may have anticipated that the ECB would speak to a faster QT in the second half of the year. We think that is still coming, but maybe it was too much to hope for a faster QT when QT hasn't even begun (March 2023 at a pace of €15/month until June).

Guidance: hazy after March—that may be the right call

In a guidance faux-pas, Lagarde intimated in the presser that the 50bps guidance for March is “strong [...] but not irrevocable”, thus keeping a chance of a 25bps move at that meeting priced in. She also noted that there was a “very large consensus” to hike 50bps today—insinuating that there were a few voters in favour of a quarter-point increase.

Tip-toeing around the size of hikes so soon after a very hawkish press conference in December—and even in light of hawkish comments by officials in the lead-up to today's announcement—works against the confidence in markets that the ECB will follow through on its guidance. Note also that already markets are doubting the Fed's commitment to not cut rates this year and the Fed generally has a better track record of sticking to hawkish guidance than the usually-dovish ECB (certainly pre-mid-2022).

Now, it is not necessarily wrong or a mistake that Lagarde reeled in the bank's hawkishness given the dramatic decline in wholesale energy prices from levels that were incorporated in the December forecasts round. Simply put, there's no way around the fact that were the ECB's forecasts to be run today, they would show lower inflation across the forecasting period. In fact, we should welcome this development as this would mean that the ECB has to depress the demand side of the economy by less than what was warranted by the December projections. She teed up a lower inflation profile in the presser in line with lower energy prices and she said the risks for inflation and growth are more balanced, with a more resilient than anticipated economy.

Overall, markets may not have yet been ready to see hesitation on the ECB's commitment to a high pace and level of hikes a few weeks after a fireworks-filled December decision. We continue to anticipate a 50bps hike in March while we see risks tilted towards a quarter-point increase in May to be followed by a final equivalent hike in June. Like the ECB, we remain data-dependent and cannot yet confidently bank on inflation pressures not remaining elevated in coming months—but a continued negative trend in headline inflation even if accompanied by stubbornly high (but cresting) core inflation has a calming effect on wages pressures and the risk perception of policymakers. With several months' worth of data until mid-year that could show continued declines in inflation, as expected, the bank may find little motivation in hiking again three meetings from today and instead choose to hold its fire in June ahead of a long pause.

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