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UNITED KINGDOM

Bank of England to diverge from the Fed as inflation remains cool

Contrary to market pricing, we think the combination of a fragile jobs market and cooling core inflation should help unlock Bank of England rate cuts in 2027

Markets see three Bank of England rate hikes ahead. We think at least one cut is more likely

The UK is not like the US – rates are still restrictive

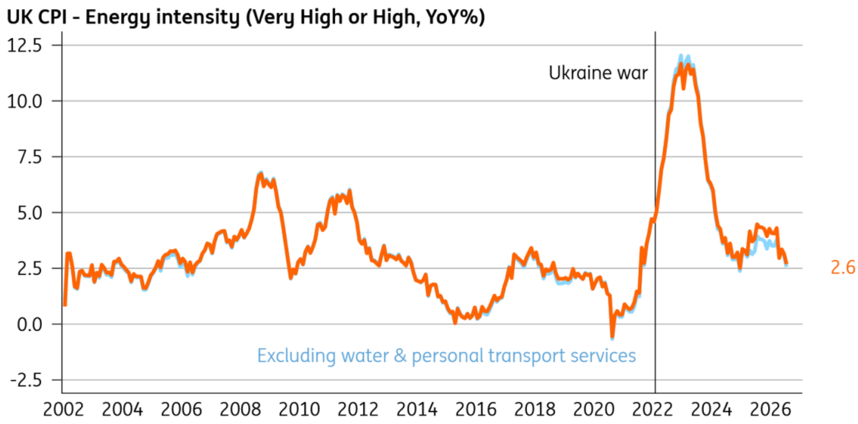
US Fed Chair Kevin Warsh's hawkish antics at Jackson Hole, together with the latest rise in energy prices, mean markets are now pricing three rate hikes from the Bank of England over the next 12 months.

We disagree; we think the Bank will have cut rates at least once by then. Warsh's argument that the level of US interest rates is no longer restrictive is much harder to make in Britain.

Take the jobs market. The good news is that private sector hiring, outside of hospitality and retail, is no longer falling, according to the payroll numbers. The bad news is that the hiring surveys generally still point to further reductions in headcount. And in consumer services, payroll numbers are falling in excess of 3% annualised, and that rate of decline, if anything, is still getting worse.

The result is that private sector wage growth, at 2.8%, is hitting new lows. And even after adjusting for so-called 'compositional effects' in the data, it has finally reached the 3.25% level which the BoE told us earlier this year is consistent with a 2% inflation target in the medium term. Forward-looking surveys don't point to an imminent turnaround.

'Energy intensive' inflation hasn't picked up



Source: Macrobond, ING

Based on energy intensity data from the ONS. Calculations by ING

Growth is likely to slow as the year goes on

All of that is hard to square with the solid growth data in the first half of the year. In part, that is simply because the inflation shock hasn't been as bad as it could have been. But there are three broader problems with this.

First, ever since 2022, growth has been much stronger in the first half of the year than the second – and the trajectory of monthly GDP this year has very much followed this familiar path. We, like many others, suspect that this is down to seasonal adjustment challenges. And that points to weaker growth in the second half of the year.

Second, growth is very concentrated. This isn't new, admittedly, but three sectors – IT, health/social care and transport – are contributing half of the UK's 1.1% annual growth rate, despite only making up 17% of economic output. Strong CapEx in the first half tentatively suggests the UK is benefiting from a scaled-down version of the AI data centre boom currently engulfing the US.

Third, construction has been very weak. Private housebuilding is still 20% below pre-Covid levels, a neat encapsulation of tight monetary policy in a rate-sensitive sector.

Then there's inflation. Our calculation of 'energy intensive' inflation has actually fallen so far this year, even accounting for the impact of last year's water and road tax hikes. There are lags involved, admittedly. But the fact that food inflation in particular has been falling should be welcome news for the BoE hawks. The Bank's favoured measure of "core services" inflation is also down so far this year.

Barring a sustained and material spike in energy prices, we think by early next year the BoE will be comfortable pivoting in a more dovish direction. A lot will depend on October's budget. But for now, we're pencilling in a rate cut for April 2027.

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