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Preview: BoE Pauses Easing Cycle, as Neutral Rate Approaches and the MPC Remains Divided

by

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Executive Summary

- **Expected Decision**: *In line with consensus, we expect the Bank of England (BoE) to hold Bank Rate by 25 bps (BR) at 3.75% in February*. Regarding its *balance sheet policy*, in September 2025, the BoE cut gilt holdings by £70bn over the next year (down from £100bn), reducing the stock to £488bn. The plan includes £21bn of active sales, up from £13bn, with fewer maturities expected; only 20% will be long-dated gilts, versus a third previously. Regarding *forward guidance,* we expect the BoE to reiterate that decisions are taken meeting by meeting.
- **Policy Discussion**: *Little has changed since December, making a February rate cut unlikely and signalling minimal shifts at the upcoming meeting.* Most economists expect the Bank of England to keep Bank Rate unchanged at 3.75% on February 5, in line with market pricing, with expectations for near-term easing having softened compared with December.

  Recent data showing the strongest private-sector growth since April 2024, firmer retail sales, and inflation still above the MPC's 2% target have reduced pressure for immediate easing. While inflation is expected to fall and wage growth to slow as unemployment rises, the data are not yet compelling enough to justify another cut.

  At the same time, divisions within the MPC persist. Policymakers such as Megan Greene have warned that wage growth—still expected to run around 3.5% in 2026—could keep inflation elevated, even as headline inflation falls on the back of one-off factors. This caution helps explain why markets now push rate cuts toward March and beyond, despite pricing roughly 40bp of easing by end-2026.
- **Changes to Economic Forecasts:** *Inflation is expected to ease toward the 2% target in the first half of the year, helped by lower energy bills, easing tax effects, and moderating price pressures***.** However, the interest-rate path remains uncertain. There is no clear consensus beyond the current quarter, even though the median forecast points to a final cut to 3.25% in Q3, with economists split between 3.25%, 3.00%, and 2.75%. While inflation dynamics are improving, policymakers remain cautious, with divisions within the MPC persisting amid uncertainty over how quickly inflation pressures will fade, ongoing geopolitical risks, higher gas prices, and sticky services inflation.

Key Picture: BoE Key Forecasts

	Latest Reading	2025*f*		2026*f*		2027*f*		2028
		November Report	August Report	November Report	August Report	November Report	August Report	November Report
GDP *(real growth, y-o-y)*	1.3	**1.5**	**1.3**	**1.2**	**1.3**	**1.5**	**1.3**	**1.2**
Unemployment rate *(%, y-o-y)*	5.1	**5.0**	**4.8**	**5.0**	**5.0**	**5.0**	**4.8**	**5.0**
CPI inflation *(%, y-o-y)*	3.6	**3.5**	**3.8**	**2.5**	**2.5**	**3.5**	**3.8**	**2.5**
Bank rate *(%)*	4.00	**3.9**	**3.8**	**3.5**	**3.5**	**3.9**	**3.8**	**3.5**

Source: Bank of England *'Monetary Policy Report'* (MPR), November and August 2025. *Note:* 1. GDP reading for Q3 2025; 2. Unemployment reading for October 2025; 3. Inflation reading for October 2025; 4. Bank Rate as implied by forward market interest rates.

Analysis

- **EXPECTED DECISION**: *On February 5, in line with consensus, we expect the Bank of England (BoE) to hold its Bank Rate at 3.75%.* With inflation still the highest among G7 peers, the nine-member Monetary Policy Committee has remained extremely divided, most recently voting 5-4 in December to approve a quarter-point rate cut.

  In terms of *forward guidance*, the Bank will remain evidence-based, and data dependent, with decisions made meeting-by-meeting. The MPC will continue to monitor closely the risks of inflation persistence and will decide the appropriate degree of monetary policy restrictiveness at each meeting.

  In terms of *balance sheet policy*, the BoE agreed to cut its government bond holdings by £70 billion (from £100 billion) over the next year, bringing the total to £488 billion. The plan includes £21bn of active bond sales, up from £13bn last year, with fewer maturities expected. Only 20% of sales will be long-dated gilts, down from a third previously. Catherine Mann favoured a £62bn reduction, while Huw Pill backed the idea of keeping a pace of £100bn a year of reduction. BoE governor Andrew Bailey said the new QT target allows the Bank to shrink its balance sheet in line with policy goals while limiting disruption to gilt markets.

- **POLICY DISCUSSION:** *Little has changed since December, making a February cut unlikely and signalling shifts minimal.* By March, however, additional jobs, wage, and inflation data should give the MPC enough confidence to ease further, especially given how finely balanced the committee remains.

  Most economists expect the Bank of England to keep Bank Rate unchanged at its February 5 meeting, with only two of 56 surveyed forecasting a cut to 3.50%. Markets are similarly priced for a hold. Expectations for near-term easing have softened. Only 55% now anticipate a cut by end-March, down from 72% in December, reflecting MPC caution and calls—highlighted by Sanjay Raja—for more evidence before the next move. While inflation remains the highest among major developed economies, it is expected to ease as past utility and tariff increases drop out. The BoE is widely expected to hold rates at 3.75% on February 5, with markets pricing roughly 42bp of cuts by end-2026.

  The decision to hold Bank Rate this month is likely to be less contentious after data showed the strongest private-sector growth since April 2024, stronger-than-expected retail sales, and inflation moving further above the MPC's 2% target. While inflation is expected to ease and wage growth to slow as unemployment rises, the data are not yet strong enough to support another rate cut. There are also early signs that the housing market is stabilising as post-budget uncertainty fades.

  BoE policymaker Megan Greene warned that wage growth could keep UK inflation above target, citing surveys pointing to pay rises of around 3.5% in 2026, well above the roughly 3% she sees as consistent with 2% CPI. While headline inflation is expected to fall toward target this spring, Greene argued this largely reflects one-off factors and said forward-looking wage indicators are more concerning. Greene, who voted against the BoE's December rate cut, also cautioned against following aggressive rate cuts by the Federal Reserve. She argued that Fed easing could ultimately push UK inflation higher by lowering borrowing costs and boosting asset prices, strengthening the case for a slower pace of monetary easing in the UK.

- **CHANGES TO ECONOMIC FORECASTS:** *Inflation is expected to ease, but interst rate puth remains unclear.* There is no clear consensus on interest rates beyond the current quarter, even though the median forecast points to a final cut to 3.25% in Q3. Most economists still expect rates to bottom at 3.25% or lower, with opinions split between 3.25%, 3.00%, and 2.75%. Markets have ruled out a February cut and instead price easing to resume from June, following the latest reduction to 3.75%.

  The BoE expects inflation to fall in the first half of the year as energy bills decline and growth remains weak, with inflation nearing the 2% target by Q2. Governor Andrew Bailey has said inflation should be close to target by April or May, with current readings slightly below the BoE's November projections. Inflation is likely to dip from January as the VAT impact on private school fees drops out and water bill increases moderate from April.

Despite softer inflation dynamics, policymakers remain cautious. Financial markets still price one or possibly two quarter-point cuts in 2026, but divisions within the MPC persist amid uncertainty over how quickly inflation pressures will fade, lingering geopolitical risks, higher gas prices, and sticky services inflation. Recent stronger activity data ease pressure for near-term easing, with economists viewing the improvement as a rebound rather than a sustained acceleration, though it suggests the economy may enter 2026 with slightly better momentum than previously expected.

- **MACROECONOMIC ANALYSIS:** *The economy expanded 0.3% in November, exceeding forecasts and bouncing back from October's contraction, led by stronger services activity and a rebound in manufacturing.* The UK economy grew just 0.1% in Q3, below expectations of 0.2%, marking a slowdown from 0.3% growth in Q2. The weakness was driven by softer services and construction, alongside a contraction in production. Manufacturing was hit particularly hard by a cyber attack at Jaguar Land Rover, which disrupted car production for five weeks, compounded by a decline in pharmaceuticals.

  The economy grew 0.3% in November, marking the strongest growth strongest since June, and was supported by normalized car production and stronger consumer-facing activity, while three-month growth also surprised on the upside.

  Inflation inflation climbed more than expected to 3.4% in December, up from 3.2% in November, driven mainly by higher tobacco duties and airfares. Core inflation held at 3.2%, slightly below expectations, while services inflation—a key gauge for policymakers—rose to 4.5%, underscoring persistent underlying price pressures. Wage growth cooled to 3.6% in the three months to November, its weakest pace in five years, offering some reassurance on the medium-term outlook.

  British business confidence weakened in January as firms' assessment of the global economic outlook fell to a one-year low, according to a survey by Lloyds Banking Group. The Lloyds Business Barometer slipped to +44% from +47%, driven by a sharp drop in economic optimism amid renewed tariff threats from the U.S.

  Despite this, confidence in firms' own activity improved, with expectations rising to a three-month high. Hiring plans strengthened for the first time in three months and wage growth expectations increased, suggesting businesses remain focused on growth and resilient to external risks.
- **MARKET IMPLICATIONS**: UK gilts could outperform if the Bank of England cuts rates more than expected, pushing yields lower. Sterling may weaken if UK easing outpaces the ECB and Fed, while further rate cuts could lower mortgage rates and support the broader economy. To put things into context, *in the fixed-income space,* as of February 2 since the last meeting on December 18: *i)* the *2y Gilt yield* is virtually unchanged to around 3.72% (-2 bps y-t-d); and *ii)* the *10y Gilt yield* edged up by 3 bps to 4.51% (-4 bps y-t-d). *In the currency space,* the British pound strengthened on dollar weakness, driven by tariff threats, uncertainty over Fed policy, and steady UK rate expectations. As of February 2, *GBP/USD* rose by 2.3% from the last meeting in December to 1.37 (+1.7% y-t-d). *GBP/EUR* also increased by 1.4% since the December meeting to around 1.16 (+0.6% y-t-d). *In the equity space,* FTSE 100 gained, driven by a rally in Lloyds shares, despite softer UK lending data and declines in mining stocks. Since the last meeting in December, the FTSE 100 increased by 5.2% and currently trades around 10.276,70 at (+3.3% y-t-d).

- **APPENDIX (MACRO ASSESSMENT):** *UK economy barely grows in third quarter.* In Q3, the economy advanced marginally by 0.1% q-o-q (*p:* 0.2%) meeting the market expectations. *Household expenditure* and *government consumption* rose by 0.2% (*p:* 0.0% in Q2) and by 0.4% (*p:* 1.2% in Q2) respectively. G*ross fixed capital formation* expanded by 1.3% (*p:* -0.9% in Q2). There was an increase in net trade, with exports increasing by 0.3% (*p:* 0.1%) and imports rising by less by 0.2% (*p:* -0.1%). The British economy expanded 1.3% y-o-y (*c:* 1.2%; *p:* 1.4%) in Q3. The British economy advanced by 0.3% m-o-m in November (*c*: 0.1%; *p*: -0.1%).

UK private-sector activity recorded its fastest growth since April 2024, according to a flash estimate. *Retail sales volumes* rose 2.5% y-o-y *(c:* 1.0%; *p:* 1.8%) in December. When looking at business confidence, in January, the *S&P Global/CIPS Flash UK Composite PMI* edged up to 53.9 (*c*: 51.5; *p*: 51.4). Services PMI increased to 54.3 (*c:* 51.7; *p:* 51.4). Manufacturing PMI was up to 51.6 (*c:* 50.6; *p:* 50.6).
UK jobless rate rose to the highest level since the three months to March 2021. In November, unemployment rate stood at 5.1% (*c:* 5.0%; *p:* 5.1%). Total average weekly earnings, including bonuses, increased by 4.7% y-o-y (*c*: 4.6%; *p*: 4.8%) in the three months leading up to November. Average wages rose in real terms, with an annual change of 4.5% excluding bonuses. The number of job vacancies increased to 734K in November.
UK inflation rises for first time in five months. In December, CPI inflation rose to 3.4% y-o-y (*c:* 3.3%; *p:* 3.2%). Core inflation stood at 3.2% y-o-y (*c:* 3.2%; *p:* 3.2%). Alcohol and tobacco drove the increase, with prices up 5.2% (vs. 4.0% in November). Prices accelerated for food and non-alcoholic beverages to 4.5% (vs 4.2%). Services inflation, a key gauge of domestic price pressures for the BOE, edged up slightly to 4.5% from 4.4%.