MONETARY AFFAIRS:

Preview: BoE on Hold in July, Amid Increased Inflationary Pressures

by

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Executive Summary

- **Expected Decision**: *In line with consensus, we expect the Bank of England (BoE) to hold Bank Rate at 3.75% in July*. Governor Bailey supported keeping rates at 3.75% in June and has indicated that higher market rates allow policymakers more time to evaluate whether the Iran war will require further monetary tightening. 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. The BoE remains in wait-and-see mode as stagflation risks complicate the policy outlook. While policymakers are expected to leave rates unchanged this week despite the recent oil price spike, persistent energy-driven inflation could still warrant further tightening if second-round effects emerge, increasing borrowing costs and limiting the government's fiscal flexibility.
- **Policy Discussion**: *Following last week's oil price surge, markets briefly priced in a two-thirds probability of a 25bp Bank of England rate hike in September and nearly three increases by June 2027,* although lower oil prices later eased expectations. Most economists, however, still expect the Bank to remain on hold this year, citing softer inflation and labour market data.

  While inflation remains above the 2% target, underlying price pressures continue to moderate. Consecutive downside inflation surprises, easing wage growth and a softer labour market suggest second-round effects remain limited, with the Bank's latest forecasts placing peak inflation at around 3.25%.

  Attention is also shifting to quantitative tightening (QT). Markets expect the Bank to slow annual gilt sales from £70bn to around £50bn, easing upward pressure on long-term yields and reducing the need for further rate hikes. Overall, the evidence continues to favour a prolonged policy pause. Unless higher energy prices trigger broader inflationary pressures, the Bank is expected to keep rates unchanged through 2026, with rate cuts likely to begin in spring 2027.
- **Changes to Economic Forecasts:** *The recent rise in energy prices presents a renewed challenge for the Bank of England but is unlikely to prompt an immediate policy response.* While the Bank's latest projections place peak inflation at around 3.25%, they do not fully reflect recent increases in wholesale energy prices. If elevated oil and gas prices persist, inflation could instead peak closer to 3.5–4.0%, increasing the likelihood of further monetary tightening.

Key Assumptions and Judgements In Scenarios from May MPR

	Scenario A	Scenario B	Scenario C
Energy prices	Energy prices for oil and gas follow the market futures curves over the scenario period.	Energy prices follow the market futures curves for six months and then follow the average of the futures curves and a constant spot price at six months for the remainder of the scenario period.	Energy prices rise sharply-to a level in the upper tail of option-implied distributions- and remain elevated for a prolonged period.
Second-round effects from new energy shock	No second-round effects from the new energy shock due to weaker worker bargaining and firm pricing power stemming from weaker demand, driven by less consumption smoothing than in other scenarios.	Modest additional second-round effects, consistent with some wage effects from the scale of the energy shock.	Stronger and more persistent additional second-round effects, relative to the other scenarios stemming from greater effect of the energy shock to inflation expectations and wages and prices.

Source: Bank of England

Analysis

- **EXPECTED DECISION**: *On July 30, in line with consensus, we expect the Bank of England (BoE) to hold its Bank Rate at 3.75%.* The BoE is firmly in wait-and-see mode, as stagflation risks, slow growth, rising unemployment, and persistent inflation, complicate policy choices. The BoE is widely expected to keep interest rates unchanged this week, with neither economists nor financial markets pricing in a rate increase, despite oil prices rising above $100 per barrel, which could test its resolve to avoid tightening policy in response to the US-Iran conflict. However, the medium-term policy outlook remains uncertain as persistent inflationary pressures and higher energy prices could require further monetary tightening. Any additional rate hikes would complicate the new government's efforts to lower living costs while increasing borrowing costs ahead of its first autumn budget.

  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.

- **POLICY DISCUSSION:** *Following last week's surge in oil prices, financial markets briefly priced in a two-thirds probability of a 25bp BoE rate hike in September and nearly three rate increases by June 2027.* Although lower oil prices subsequently reduced expectations, investors continue to fully price in one rate hike by November. In contrast, most economists still expect the Bank to remain on hold this year, arguing that recent economic data do not yet justify additional monetary tightening.

  Despite inflation remaining above the Bank's 2% target, policymakers appear increasingly confident that underlying price pressures are easing. The delayed pass-through of higher wholesale energy prices into regulated household utility bills has temporarily kept UK inflation below that of the United States and the euro area, providing the Bank with greater scope to look through the initial energy shock. At the same time, three consecutive downside inflation surprises, moderating wage growth and a softening labour market suggest that second-round inflationary effects remain limited. The Bank's latest projections also place peak inflation at around 3.25%, while current oil and natural gas futures remain broadly consistent with its existing energy price scenarios, reducing the immediate case for further tightening.

  Alongside interest rate decisions, attention is increasingly turning to the Bank's quantitative tightening (QT) programme. Policymakers are expected to review the pace of gilt sales ahead of September's Monetary Policy Committee meeting, with markets anticipating a reduction in annual bond sales from £70bn to around £50bn. A slower pace of QT would help limit upward pressure on long-term gilt yields and could lessen the need for additional policy rate increases if financial conditions tighten further.

  Overall, the balance of evidence continues to support a prolonged policy pause. Food and core services inflation are easing, while business surveys indicate limited pass-through of higher energy costs into wages and broader prices. Unless energy prices rise substantially enough to push inflation materially above current projections and trigger stronger second-round effects, the Bank of England is likely to keep rates unchanged through 2026. Under the baseline scenario of stabilising energy markets and no material fiscal stimulus in the Autumn Budget, rate cuts are expected to begin in spring 2027, although a sustained escalation in energy prices remains the principal upside risk to this outlook.

- **CHANGES TO ECONOMIC FORECASTS:** *The recent rise in energy prices presents a renewed challenge for the BoE, although it is unlikely to trigger an immediate policy response.* The Bank's latest projections continue to suggest inflation will peak at around 3.25%, while current oil and natural gas futures remain broadly consistent with its baseline energy price scenarios, limiting the immediate case for additional monetary tightening. Accordingly, markets continue to expect rates to remain unchanged in the near term.

Nevertheless, inflation risks remain tilted to the upside. The Bank's published forecasts do not fully capture the latest surge in wholesale energy prices, implying that inflation could prove stronger than currently projected. If elevated oil and gas prices persist, inflation could instead peak closer to 3.5-4.0%, increasing the risk of more persistent price pressures and strengthening the case for tighter monetary policy.

- **MACROECONOMIC ANALYSIS:** *The UK economy showed mixed but improving momentum over recent months*. GDP rebounded by 0.1% in May after a 0.1% contraction in April, suggesting greater resilience to Iran war-related energy shocks than initially feared, although growth remained uneven as stronger services activity offset weakness in production and construction. The economy expanded 0.6% in Q1 2026, driven by services, but falling real disposable income, a lower household savings ratio and softer activity in April point to a more moderate growth trajectory. While GDP increased 0.7% over the three months to May, renewed Middle East tensions, elevated energy prices and weak consumer demand continue to weigh on the outlook.

  Business activity improved noticeably in July. The S&P Global UK Composite PMI rose to 52.1, returning to expansion after two months of contraction, with both manufacturing and services strengthening. Manufacturing recorded its strongest increase in new orders in four years, while easing logistics disruptions reduced input cost pressures. However, elevated labour costs continued to constrain hiring despite improving demand.

  Inflationary pressures eased but remain persistent. Headline CPI slowed more than expected to 2.6% in June, the lowest since March 2025, largely due to lower fuel prices following a temporary de-escalation in the Iran conflict. However, services inflation remained elevated at 3.6%, while core inflation held at 2.6%, indicating persistent underlying price pressures. With renewed geopolitical tensions pushing energy prices higher again, inflation is expected to reaccelerate toward 3-3.5% later this year.

  The labour market continued to soften gradually. The unemployment rate remained unchanged at 4.9%, while job vacancies declined further and private-sector wage growth moderated, suggesting easing labour market tightness without a significant deterioration in employment. Against this backdrop, markets expect the BoE to keep rates unchanged in the near term while maintaining a cautious tightening bias as it balances slowing growth against persistent inflation.
- **MARKET IMPLICATIONS**: *Bank of England and the new Prime Minister have an impact on gilt prices.* Prime Minister Andy Burnham reaffirmed his commitment to the government's fiscal rules but signalled a willingness to use available fiscal flexibility to support tax relief and public spending. Markets reacted cautiously, pushing gilt yields above 5% as investors remained sensitive to signs of fiscal loosening. High borrowing costs continue to reflect persistent inflation, elevated public debt and uncertainty over the economic impact of the Iran war, leaving fiscal credibility a key focus for investors. *in the fixed-income space,* as of July 27and since the last meeting on June 18: *i)* the *2y Gilt yield* edged up by 19 bps to 4.39% (+65 bps y-t-d); and *ii)* the *10y Gilt yield* was up by 19 bps to around 4.95% (+41 bps y-t-d). *In the currency space,* Sterling edged higher as lower oil prices weakened the US dollar and improved global risk sentiment amid renewed hopes for US-Iran negotiation. As of July 27, *GBP/USD* increased by 0.7% from the last meeting in June to 1.33 (-1.2% y-t-d). *GBP/EUR* rose by 1.5% since the June meeting to around 1.17 (+1.9% y-t-d). *In the equity space,* the FTSE 100 advanced as a two-year high in Unilever shares more than offset declines in Barclays and weakness across the semiconductor sector. Since the last meeting in June, as of July 27, the FTSE 100 rose by 3.7% to 10.781,75 (+8.4% y-t-d).

- **APPENDIX (MACRO ASSESSMENT):** *Despite April's dip, the economy proved more resilient to Middle East-driven energy price increases than many analysts had expected.* In Q1, the economy advanced by 0.6% q-o-q (*c:* 0.6%; *p:* 0.2%) marking the strongest growth since Q1 2025. *Household expenditure* and *government consumption* rose by 0.6% (*p:* 0.1% in Q4) and by 0.4% (*p:* 0.1% in Q4) respectively. G*ross fixed capital formation* shrank by 0.6% (*p:* -0.1% in Q4). Business investment increased by 0.7% q-o-q (*p:* -2.9%). There was a decrease in net trade, with imports increasing by 0.6% (*p:* 0.6%) and rises by less by 0.1% (*p:* -0.3%). The British economy expanded 0.9% y-o-y (*c:* 0.9%; *p:* 1.1%) in Q1. The British economy expanded by 0.1% m-o-m in May (*c*: 0.1%; *p*: -0.1%).

  UK Composite PMI returned to expansion after two months of contraction. *Retail sales volumes* climbed 4.2% y-o-y *(c:* 2.3%; *p:* 3.5%) in June. When looking at business confidence, in July, the *S&P Global/CIPS Flash UK Composite PMI* rose to 52.1 (*c:* 49.7; *p:* 49.3). Services PMI increased to 51.8 (*p:* 48.8). Manufacturing PMI was up to 52.8 (*p:* 52.5).

  The UK unemployment holds steady as private-sector wage growth slows. In May, unemployment rate was unchanged at 4.9% (*c:* 5.0%). Total average weekly earnings, including bonuses, increased by 4.3% y-o-y (*c*: 4.5%; *p*: 4.4%) in the three months leading up to May. Average wages rose in real terms, with an annual change of 3.4% excluding bonuses. The number of job vacancies increased to 712K in May (*p*: 710K).

  Inflation cooled more than expected last month as a temporary de-escalation of the Iran conflict lowered fuel prices. In June, CPI inflation slowed to 2.6% y-o-y (*c:* 2.7%; *p:* 2.8%). Core inflation held steady at 2.6% y-o-y (*c:* 2.5%; *p:* 2.6%). This marked the lowest reading since March 2025, driven by easing transport inflation (5.7% vs. 6.8% in May), as lower motor fuel prices, particularly diesel, provided the largest downward contribution.

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