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MONETARY AFFAIRS:

Preview: BoE To Keep Rates on Hold,

While Further Reducing The Pace of QT

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 September*. The bar for a BoE hike remains high despite markets pricing three increases by mid-2027, so we expect a decision with minimal (if any) dissent. Economists expect rates to remain at 3.75% through at least mid-year, with inflation peaking at around 3.5%. The energy shock has delayed easing, but barring significant fiscal loosening, two cuts are expected in late 2027. 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. In September 2026 they will also vote on the next phase of QT, and we expect a further reduction of the pace of tightening (possibly to GBP 50bn), especially given the recent tensions on the long end of the yield curve. The BoE remains in wait-and-see mode as stagflation risks complicate the policy outlook.
- **Policy Discussion**: *BoE Governor Andrew Bailey pushed back against expectations of inevitable rate hikes, stressing that policy remains dependent on economic and geopolitical developments.* Despite Brent nearing $100, domestic inflation pressures remain relatively benign, with little evidence of second-round effects. Higher global yields have also tightened financial conditions, giving the BoE room to wait. Nearly 90% of economists expect rates to remain unchanged through year-end.

  Markets are more hawkish, pricing one hike by year-end and two more in 2027. Bailey suggested this partly reflects an energy-related risk premium rather than the BoE's likely policy path. Sterling rates remain particularly sensitive to oil, while fiscal expansion poses an additional upside risk. With a light data calendar, geopolitical developments and energy prices are likely to remain the main near-term drivers.

Key Assumptions and Judgements In Scenarios from July MPR

	Central projection	Milder scenario	Adverse scenario
Energy prices	Energy prices for wholesale oil and gas follow the market futures curves over the 15 UK working days to 20 July.	Energy future prices follow the paths around 1 July, capturing the lower prices after the signing of the Memorandum of Understanding (MoU).	Energy prices rise materially above the central projection and remain persistently higher over the forecast period.
Second-round effects from recent energy shock	Moderate additional second-round effects, consistent with some effect on short-term inflation expectations and hence wages. In addition, heightened attentiveness to inflation also contributes to second-round effects.	No new second-round effects from the recent energy shock, owing to weaker worker bargaining and firm pricing power. This partly reflects weaker demand, driven by a greater degree of saving than in the central projection.	Stronger and more persistent additional second-round effects relative to the central projection and milder scenario. This stems from a greater effect of the energy shock on long-run inflation expectations and hence wages and prices.

Source: Bank of England

Analysis

- **EXPECTED DECISION**: *On September 17, 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 bar for a BoE rate hike remains high despite markets pricing three increases by mid-2027, so we expect a decision with minimal (if any) dissent. Economists expect rates to remain at 3.75% through at least mid-2027, while six of nine MPC members voted to hold in July. Inflation is expected to peak at around 3.5% next winter, below the 4% level associated with greater second-round effects. The energy shock has delayed the prospect of easing, but barring significant fiscal loosening in the October budget, the BoE is expected to remain on hold before cutting rates twice in late 2027.

  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. In September 2026 they will also vote on the next phase of QT, and we expect a further reduction of the pace of tightening (possibly to GBP 50bn), especially given the recent tensions on the long end of the yield curve.

- **POLICY DISCUSSION:** *BoE Governor Andrew Bailey pushed back against expectations of inevitable rate hikes, stressing that policy remains dependent on economic and geopolitical developments.* While activity has been somewhat stronger than expected, domestic inflation pressures remain relatively benign.

  Despite Brent nearing $100, there is little evidence so far that higher energy costs are feeding into broader inflation or generating second-round effects. Higher global bond yields have also tightened financial conditions, giving the BoE more room to wait. All economists polled by Reuters expect rates to remain at 3.75% in September, while nearly 90% expect no change through year-end.

  Markets are considerably more hawkish, pricing one BoE hike by year-end and two more in 2027. Sterling rates therefore look overdone relative to central bank communication and macro fundamentals. Bailey suggested that this divergence partly reflects an inflation risk premium linked to uncertainty over future energy prices rather than the BoE's most likely policy path.

  Oil is the main source of uncertainty. Since the Middle East conflict began, every $10 increase in Brent has added around 15bp to UK 2Y rates, compared with 11bp in EUR and 8bp in USD rates. Fiscal policy is another risk, as a more expansionary Labour budget could delay eventual BoE cuts and reinforce market expectations of hikes.

  With a light data calendar, near-term sterling rates are likely to remain driven primarily by geopolitical headlines and energy prices.

- **MACROECONOMIC ANALYSIS:** *UK inflation rose to 2.9% in July from 2.6%, driven by the sharpest increase in gas prices in nearly four years, while food inflation eased to 1.3%.* The UK economy grew 0.4% in Q2, down from 0.6% in Q1 but in line with expectations, showing resilience despite the Iran war and higher energy prices. Growth was driven by the services sector, which expanded 0.5%, while business investment rose 1.7% and household consumption increased 0.3%. GDP grew 0.3% in June after stagnating in May, partly supported by World Cup-related spending. However, momentum is expected to weaken as higher energy costs squeeze household incomes and inflation rises. The BoE forecasts growth of 1.1% in 2026 and inflation reaching 3.2% later this year. Risks remain tilted to the downside if disruption to the Strait of Hormuz persists, with Treasury scenarios suggesting growth could slow to just 0.3% in 2027.

  UK services activity strengthened in August, with the PMI rising to 52.5 from 52.1, its fastest expansion since April, while the composite PMI also climbed to 52.5. Business confidence reached its highest since February and employment declined at the slowest pace since October 2025, pointing to continued resilience despite the Iran war. However, price pressures intensified as more firms reported higher input costs and selling prices, raising concerns about the pass-through of the energy shock into inflation. New business growth remained subdued, with the new work index edging down to 50.7.

UK inflation rose to a four-month high of 2.9% in July from 2.6% in June, driven largely by a 13% increase in the household energy price cap. However, underlying pressures remained relatively contained: core inflation held at 2.6%, services inflation eased to 3.4% from 3.6%, and food inflation fell to an almost two-year low of 1.3%. The BoE expects headline inflation to peak at 3.2% later this year as the Iran war continues to affect energy costs. Still, a softer labour market and easing wage growth could limit broader second-round inflationary pressures, reducing the likelihood that the energy shock becomes as persistent as in 2022.

- **MARKET IMPLICATIONS**: *Sterling approached a two-week high of $1.355 against the dollar, supported by expectations of tighter BoE policy despite surging energy prices.* Although Bailey has pushed back against expectations that higher rates are inevitable. UK 10Y gilt yields rose to 5.30%, their highest since 2007, as Brent's move above $100 pushed borrowing costs higher globally. Two- and five-year yields also reached multi-year highs, despite strong demand at the UK's £5bn gilt auction. The selloff largely reflects global pressure from higher energy prices and rising bond yields rather than UK-specific factors. *in the fixed-income space,* as of September 10 and since the last meeting on July 30: *i)* the *2y Gilt yield* edged up by 27 bps to 4.72% (+99 bps y-t-d); and *ii)* the *10y Gilt yield* was up by 29 bps to around 5.28% (+74 bps y-t-d). *In the currency space,* Sterling could weaken further against the euro in the near term as the BoE pushes back against market expectations for higher rates. GBP/EUR has repeatedly failed to sustain rallies and is testing its summer support around 1.165, leaving short-term momentum tilted to the downside. As of September 10, *GBP/USD* increased by 0.5% from the last meeting in July to 1.36 (+0.6% y-t-d). *GBP/EUR* fell by 0.3% since the July meeting to around 1.16 (+1.4% y-t-d). *In the equity space,* European stocks opened mostly higher on Thursday, while the FTSE 100 underperformed, as investors awaited an expected ECB rate hike. Since the last meeting in July, as of September 10, the FTSE 100 fell by 2.5% to around 10.623 (+6.7% y-t-d).

- **APPENDIX (MACRO ASSESSMENT):** *Britain's economy remained resilient despite the Iran war, as strong consumer spending and services supported growth.* In Q2, the economy expanded by 0.4% q-o-q (*c:* 0.4%; *p:* 0.6%). *Household expenditure* and *business investment* rose by 0.3% (*p:* 0.6% in Q1) and 1.7% (*p:* 0.9% in Q1) respectively. G*ross fixed capital formation* increased by 1.2% (*p:* 0.4% in Q1), while *government consumption* shrank by 0.3% (*p:* 1.3% in Q1). Exports were up 0.5% (*p:* 0.2% in Q1) and imports rose by 0.5% (*p:* 1.4% in Q1). The British economy expanded 1.2% y-o-y (*c:* 1.1%; *p:* 0.9%) in Q1. The British economy expanded by 0.3% m-o-m in June (*c*: 0.0%; *p*: 0.0%).

  UK services activity strengthened in August, fastest growth since April, while confidence improved despite the US-Iran war. *Retail sales volumes* rose 1.6% y-o-y (*c:* 2.2%; *p:* 3.8%) in July. When looking at business confidence, in August, the *S&P Global/CIPS Flash UK Composite PMI* rose to 52.5 (*c:* 51.6; *p:* 52.2). Services PMI increased to 52.5 (*c:* 52.8; *p:* 52.1). Manufacturing PMI was down to 51.7 (*c:* 51.5; *p:* 51.9).

  UK unemployment held steady, as firms delayed hiring amid domestic and global uncertainty. In June, unemployment rate was unchanged at 4.9% (*c:* 4.8%). Total average weekly earnings, including bonuses, increased by 4.1% y-o-y (*c*: 4.1%; *p*: 4.4%) in the three months leading up to June. Average wages rose in real terms, with an annual change of 3.5% excluding bonuses. The number of job vacancies decreased to 707K in June (*p*: 711K).

  UK Inflation rises on higher household energy bills. In July, CPI inflation rose to 2.9% y-o-y (*c:* 2.9%; *p:* 2.6%). Core inflation held steady at 2.6% y-o-y (*c:* 2.5%; *p:* 2.6%). Housing and household services inflation rose to 4.1% from 2.7%, driven by Ofgem's 13% energy price-cap hike, with gas prices surging 14.7%. Food inflation eased to 1.3% from 1.7%.