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Preview: BoE To Start a Short and Preemptive Tightening Cycle

by

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Executive Summary

- **Expected Decision**: *In line with consensus, we expect the Bank of England (BoE) to raise its Bank Rate bps 25bps to 4.00% in November*. A majority of economists expect the BoE to raise the rate, its first hike in over three years, amid persistently elevated inflation. However, expectations for further tightening remain divided, with limited evidence that the energy price shock has spread to broader consumer prices. Markets are pricing in four quarter-point hikes by the end of 2027. Regarding its *balance sheet policy*, in September 2026 the BOE unveiled a multi-year plan, under which holdings will be unwound at an average annual pace of £46 billion through £20 billion in yearly gilt sales alongside maturing bonds.
- **Policy Discussion**: *The BoE is widely expected to raise Bank Rate by 25 bps to 4.0% in November, marking its first hike in over three years, with no or minimal dissent.* A Reuters poll found that 54 of 63 economists anticipate an increase, supported by Governor Andrew Bailey's recent signals. However, the outlook for further tightening remains uncertain. Nearly half of economists expect another hike in Q1 2027, while markets price in four quarter-point increases by end-2027. Chief Economist Huw Pill has cautioned against expectations of successive hikes.

  The BoE faces a policy dilemma as it considers tightening in response to a supply-driven energy shock. Despite limited evidence of second-round inflation effects, policymakers may favour precautionary tightening to contain broader price pressures, support sterling and preserve credibility, particularly as the ECB and Fed have already raised rates. Persistent inflation also poses risks to borrowing costs given the UK's substantial index-linked debt. Some analysts anticipate another hike in February 2027, followed by potential rate cuts from November 2027 as inflation pressures ease.
- **Expected Changes to Economic Forecasts:** *The BoE is expected to revise its inflation forecasts upward in November,* reflecting stronger price pressures and a resilient labour market. Headline inflation rose to 3.5% y-o-y in September from 3.1%, while core and services inflation reached 2.8% and 3.7%, respectively. Underlying services inflation climbed to 3.9%, its highest since March. Some analysts expect inflation to peak at 4.8% in February 2027 and remain above 4% until July, raising concerns about second-round effects. Meanwhile, unemployment unexpectedly fell to 4.7% and regular wage growth remained at 3.7%, suggesting less labour market slack than previously anticipated.

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

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Analysis

- **EXPECTED DECISION**: *On November 5, in line with consensus, we expect the Bank of England (BoE) to hike its Bank Rate by 25 bps to 4.0%.* It will mark the first hike in over three years, amid persistent inflation and rising energy costs. We expect no, or just minimal dissent on the part of the most dovish members.

  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*, in September 2026 the BOE unveiled a multi-year plan, under which holdings will be unwound at an average annual pace of £46 billion through £20 billion in yearly gilt sales alongside maturing bonds.

- **POLICY DISCUSSION:** *The BoE is widely expected to raise Bank Rate by 25 bps to 4.0% in November, marking its first hike in over three years*. A Reuters poll found that 54 of 63 economists anticipate an increase, while Governor Andrew Bailey has signalled that tighter policy may be necessary. However, expectations for subsequent hikes remain divided. Nearly half of economists foresee another increase in Q1 2027, while financial markets price in four quarter-point hikes by the end of next year. BoE Chief Economist Huw Pill has cautioned against expectations of successive rate increases.

  The central policy dilemma is whether to tighten monetary policy in response to a largely supply-driven inflation shock. Although evidence of second-round effects remains limited, policymakers may favour a precautionary hike to prevent higher energy costs from feeding into broader prices and wages. Moreover, with the ECB and Fed already tightening, keeping rates unchanged could weaken sterling, exacerbate imported inflation and undermine confidence in the BoE's commitment to price stability. Elevated government borrowing costs and the UK's substantial share of index-linked debt further heighten concerns about persistent inflation.

  Looking ahead, the policy outlook will depend largely on whether energy-driven inflation becomes entrenched. Some analysts expect further tightening in February 2027, followed by a pause as policymakers assess incoming data. If second-round effects remain contained and inflation pressures ease, the BoE could begin reversing rate increases from November 2027, with further cuts possible in 2028.

- **EXPECTED CHANGES TO ECONOMIC FORECASTS:** *The BoE is expected to revise its inflation forecasts upward in November*, reflecting stronger-than-expected price pressures and a more resilient labour market. Headline inflation accelerated to 3.5% y-o-y in September from 3.1% in August, while core and services inflation reached 2.8% and 3.7%, respectively. Underlying services inflation rose to 3.9%, its highest since March, suggesting persistent domestic price pressures. Some analysts expect headline inflation to peak at 4.8% in February 2027 and remain above 4% until July, raising concerns about second-round effects. Meanwhile, unemployment unexpectedly declined to 4.7%, while regular wage growth remained stable at 3.7%, potentially prompting the BoE to revise its labour market outlook and reassess the degree of economic slack.

- **MACROECONOMIC ANALYSIS:** *UK economic growth exceeded expectations in August despite slowing from July, while rising inflation and a cooling labour market highlighted persistent economic challenges*. However, business activity strengthened in October, signalling improving momentum. The economy expanded by 0.5% q-o-q in Q2 2026, revised up from 0.4%, supported by growth in services, construction and net exports. Annual GDP growth accelerated to 1.4%. In August, GDP rose by 0.1% m-o-m, beating forecasts of a 0.1% contraction but slowing from 0.4% growth in July. The expansion was driven by a 0.8% increase in industrial output, which offset stagnation in services and a 0.2% contraction in construction. Annual GDP growth accelerated to 2.1%, supported by strong activity in technology-related sectors.

  Meanwhile, inflationary pressures intensified in September, with headline inflation rising to 3.5% y-o-y from 3.1%, exceeding forecasts of 3.4% and reaching its highest level in nearly a year. The increase was driven

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primarily by a 29.8% surge in motor fuel prices. Core inflation climbed to 2.8% from 2.6%, while services inflation accelerated to 3.7% from 3.4%. On a monthly basis, consumer prices rose by 0.4%.

Labour market conditions remained mixed. Unemployment unexpectedly declined to 4.7% in the three months to August from 4.9%, its lowest level in over a year, while payroll employment increased by 13,000 to 30.3 million in September. However, job vacancies fell by 21,000 to 691,000, their lowest since 2021, as smaller firms reduced hiring amid rising labour costs. Regular wage growth remained stable at 3.7% y-o-y, while total earnings growth slowed to a nearly six-year low of 3.7%.

Despite these challenges, more recent indicators pointed to strengthening economic activity in October. The flash Composite PMI rose to an eight-month high of 53.1 from 52.0 in September, supported by stronger services and manufacturing activity. The Services PMI reached an eight-month high of 53.1, while manufacturing output climbed to a 25-month high of 53.1 and the Manufacturing PMI increased to 52.8, suggesting an improvement in private sector momentum at the start of Q4.

- **MARKET IMPLICATIONS**: *Markets remain wary of policy developments after the UK budget.* The UK 10-year gilt yield fell to a five-week low of around 5.30%, as Finance Minister John Healey's restrained, fiscally neutral budget reassured bond markets. *in the fixed-income space,* as of October 30 and since the last meeting on September 16: *i)* the *2y Gilt yield* edged up by 13 bps to 4.89% (+115 bps y-t-d); and *ii)* the *10y Gilt yield* was down by 1 bps to around 5.29% (+75 bps y-t-d). *In the currency space,* the British pound strengthened against the US dollar, with GBP/USD approaching 1.3400, supported by expectations of BoE rate hikes in November and February. As of October 30, *GBP/USD* increased by 0.2% from the last meeting in September to around 1.34 (-0.3% y-t-d). *GBP/EUR* increased by 2.6% since the September meeting to around 1.20 (+4.3 y-t-d). *In the equity space,* since the last meeting in September, as of October 30, the FTSE 100 rose by 0.6% and at the time of writing trades around 10,757 (+8.1% y-t-d). UK equities edged higher on Thursday, with the FTSE 100 gaining 0.26% and the FTSE 250 rising 0.14%, supported by strong Shell earnings, while expectations for further rate hikes remained largely unchanged. FTSE 100 futures pointed to a marginally positive open amid continued focus on the UK fiscal outlook.

- **APPENDIX (MACRO ASSESSMENT):** *UK monthly GDP growth exceeds August forecasts, driven by stronger industrial production.* in Q2, the economy expanded by 0.5% q-o-q (*c:* 0.4%; *p:* 0.6%). *Household expenditure* and *business investment* rose by 0.3% (*p:* 0.7% in Q1) and 1.8% (*p:* 3.0% in Q1) respectively. G*ross fixed capital formation* increased by 0.9% (*p: 1.8%* in Q1), while *government consumption* shrank by 0.5% (*p:* 1.0% in Q1). Exports were up 2.8% (*p:* -0.1% in Q1) and imports stalled (*p:* 1.4% in Q1). The British economy expanded 1.4% y-o-y (*c:* 1.2%; *p:* 0.8%) in Q1. The British economy expanded by 0.1% m-o-m in August (*c*: -0.1%; *p*: 0.4%).

  The UK Composite PMI rose to an eight-month high, beating forecasts, as new business grew at its fastest pace since September 2024. *Retail sales volumes* rose 0.8% y-o-y *(c:* 1.0%; *p:* 2.7%) in September. When looking at business confidence, in August, the *S&P Global/CIPS Flash UK Composite PMI* rose to 53.1 (*c:* 51.8; *p:* 52.0). Services PMI increased to 53.1 (*c:* 51.8; *p:* 52.1). Manufacturing PMI was up to 52.8 (*c:* 51.7; *p:* 51.9).

  Unemployment fell to its lowest level in over a year, while vacancies continued to decline as smaller firms scaled back hiring. In June, unemployment rate edged down to 4.7% (*c:* 4.9%; *p:* 4.9%). Total average weekly earnings, including bonuses, increased by 3.7% y-o-y (*c*: 3.8%; *p*: 3.9%) in the three months leading up to August. Average wages rose in real terms, with an annual change of 3.7% excluding bonuses. The number of job vacancies decreased to 691K in August (*p*: 704K).

  UK Inflation rises on higher household energy bills. In September, CPI inflation rose to 3.5% y-o-y (*c:* 3.4%; *p:* 3.1%). Core inflation increased to 2.8% y-o-y (*c:* 2.7%; *p:* 2.6%). Transport was the main driver of inflation, accelerating to 6.6% from 4.6% as motor fuel inflation rose to 29.8%. Price pressures also increased in housing, communication and recreation, while food inflation remained stable and restaurant and hotel inflation eased.

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