

## Central bank divergence is set to magnify as US dramatically outpaces Europe

We now expect multiple consecutive 50 basis point rate hikes from the Federal Reserve, taking the funds rate to 3% by early next year. Europe, by contrast, looks more cautious. The European Central Bank will stick to only ending its unconventional measures, while the Bank of England's hiking cycle looks like it doesn't have much further left to run



The ECB's Christine Lagarde and the Fed's Jerome Powell pictured in 2019

### □ Federal Reserve

The Federal Reserve has become notably more hawkish in recent weeks, culminating in a 25bp rate hike at the March FOMC, while signalling an openness to move more aggressively at upcoming meetings. Significantly, their comments suggest they are prepared to accept a weaker economy as they seek to regain control of inflation and inflation expectations.

50bp rate hikes are clearly on the cards for at least the next two or three FOMC meetings with the Fed funds rate likely to reach 3% by early 2023. The Fed is also expected to announce a shrinking of its \$9tn balance sheet from the third quarter of this year.

With the dollar also looking strong, a more restrictive monetary conditions environment increases the chances that the US economy will slow meaningfully next year. Assuming inflation also slows, this raises the possibility that the Fed reverses course in the second half of 2023. Note that over the past 50 years the average time period between the last rate hike in a cycle and the first rate cut was just eight months. We expect interest rates to peak in the first quarter of 2023 and look for rate cuts towards a more neutral footing from the end of that year.

## □ European Central Bank

With the eurozone facing the risk of stagflation, the European Central Bank's planned route to policy normalisation has come under pressure. While growth is about to test recessionary territories, at least in the first half of the year, headline inflation will be higher for longer. In such a macro-economic environment, the ECB's focus seems to have shifted to inflation and no longer growth.

However, just as the ECB couldn't do anything to bring Asian containers faster and cheaper to Europe, or to step up microchip production in Taiwan, there is nothing the ECB can do to stop the war or bring down energy prices. The ECB will want to focus on inflation expectations and as long as these expectations remain fairly anchored, we only expect an end of the so-called unconventional measures over the next twelve months. In other words, an end to net asset purchases and negative deposit rates.

It would take a clear end to the war, sanctions to be lifted and fiscal stimulus to be stepped up, to engage the ECB in a more genuine tightening cycle.

## □ Bank of England

The Bank of England has now hiked interest rates at three consecutive meetings, and we expect another move at the next one in May. But this process masks a marked change in tone over recent weeks. At February's meeting, which pre-dated the war in Ukraine, the committee narrowly voted against hiking interest rates even more aggressively (by 50bp). By mid-March, appetite for a 50bp move had faded entirely and, in fact, one member voted for no rate hike at all. That meeting saw noticeably more emphasis on the deteriorating growth outlook.

This suggests the committee's hiking cycle doesn't have much further to run, contrary to market expectations for another five rate rises this year. The hikes so far have been billed as a pre-emptive move to normalise policy rates and get ahead of inflation. But after one or perhaps two more hikes before the summer, we think the committee will signal a pause. Remember too that the next rate hike, in theory at least, will be accompanied by an announcement that the quantitative tightening process will be accelerated by selling gilts actively back into the market. These are uncharted waters, and add another reason for the Bank to tread carefully on policy rates as we enter the second half of the year.

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