

## Central banks to continue tightening despite rising uncertainty

We expect six rate hikes from the Federal Reserve this year amid rising inflation and a solid domestic backdrop. The European Central Bank is set to keep its options wide open at the March meeting when it comes to end-dates for QE and the timing of the first rate hike. Expect two more front-loaded hikes from the Bank of England, but that could be more-or-less it



ECB President, Christine Lagarde, at a summit of EU finance ministers last week in Paris

### Fed to hike six times in 2022; quantitative tightening to begin next quarter

After Jerome Powell's hawkish shift at the January FOMC meeting, markets went as far as to price a 90% chance of a 50bp Federal Reserve hike on 16 March and up to 160bp of interest rate hikes for the year. However, expectations have been scaled back sharply in response to Russia's invasion of Ukraine. At the time of writing, this has shifted lower to a mere 25bp hike in March and 140bp by the December FOMC meeting.

Russia's actions undoubtedly make the outlook far more uncertain and pose clear challenges for the global economy through higher commodity prices, more strained supply chains and

heightened anxiety. Nonetheless, the US economy is growing strongly, has very low unemployment and has inflation at 40-year highs. The US is also more economically insulated from the crisis than Europe through less direct trade and banking linkages and by virtue of being an energy producer.

It is obviously difficult to call how the geopolitical backdrop will evolve, but our central case, for now, is the Fed responds with six hikes this year and announces a gradual, passive run-down of its \$9tn balance sheet in late 2Q.

## European Central Bank returns to full flexibility

For the ECB, the overall economic picture since the start of the war in Ukraine has once again complicated the road to normalisation. In fact, the risk of stagflation has clearly increased, complicating the ECB's dilemma: how to react to accelerating inflation which cannot be softened by monetary policy.

It is hard to see the ECB wanting to start normalising monetary policy at such a moment of high uncertainty. Therefore, we expect the central bank to stick to the already announced rotation of its asset purchase programmes. That means ending the Pandemic Emergency Purchase Programme (PEPP) in March, increasing the Asset Purchase Programme (APP) from €20-40bn, and then reducing asset purchases by €5-10bn per month, starting in May.

Contrary to the December meeting, the ECB will want to avoid hinting at end dates for QE or starting dates for rate hikes. Instead, the ECB will dust off Mario Draghi's and Jean-Claude Trichet's old promise to "never pre-commit".

## Bank of England to plough on with rate hikes – but not for long

Bank of England officials are clearly nervous about the further rise in energy prices and what that means for inflation expectations at a time when wage growth is already rising quickly. However some of this is a by-product of the extra churn in the jobs market after an unusually dormant period during the pandemic, and wage pressures may slowly reduce through this year. That – and the likelihood that the recovery will grind to a halt later this year – suggest limited need to tighten much further.

We still expect the Bank to hike in March, though recent developments suggest the chances of an outsized 50bp hike are even lower than they were before. That, plus another move in May, would demonstrate that the committee is keen to act pre-emptively against the backdrop of rising inflation.

But ultimately there's only so much monetary policy can do in this environment, and we expect hikes to stop once Bank rate reaches 1%. At that point, the BoE has also said it will 'consider' selling bonds to accelerate the reduction in its balance sheet size. That's a process fraught with risks, adding another reason for the Bank to tread more carefully on rate hikes after the spring.

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