Central banks to keep hiking amid uncomfortably high inflation

Despite talk of a Fed pause, we expect the US central bank to keep hiking through the autumn, taking rates to 3% around the turn of the year. Meanwhile, the ECB has effectively pre-announced two 25bp rate hikes this summer, although rising inflation means a 50bp in July shouldn't be totally ruled out

Christine Lagarde, president of the European Central Bank

Federal Reserve

The Fed has laid out the case for 50 basis point (bp) rate hikes at both the June and July Federal Open Market Committee meetings, but there is a debate as to what happens thereafter. Some officials want the Fed to continue with 50bp hikes to ensure inflation is brought under control, but this risks moving policy deeply into restrictive territory and heightening the chances of a recession. Others argue that there is already evidence of the growth outlook weakening and inflation pressures tentatively softening, which could justify a pause in September.

We remain optimistic about near-term growth with a strong consumer performance and a positive outlook for capital expenditure pointing to GDP growth in excess of 4% in the second quarter. We also think inflation will be sticky given ongoing geopolitical strife, supply chain issues, and labour market shortages. As such, a September hike is still our base case, but there is a growing chance the Fed will switch to 25bp moves at that meeting and beyond. We expect the Fed funds rate to peak at around 3%, but the weakening housing market, softer growth, and declining inflation should pave the way for rate cuts in late 2023.

European Central Bank

The ECB has clearly passed the stage of discussing whether and even when policy rates should be increased. The only discussion seems to be on whether the ECB should start with a 25bp rate hike in July, or move faster with a 50bp hike. It is the ECB's self-determined 'sequencing', ie first, end net asset purchases before hiking rates, which stops the ECB from hiking in June. The 21 July meeting will be the crucial meeting for the rate lift-off.

Both ECB president Christine Lagarde and chief economist Philip Lane have tried to take back control of the discussion on 50bp vs 25bp, breaking with the ECB's traditional communication strategy to never pre-commit. Instead, Lane spelled out the roadmap for normalising monetary policy, de-facto announcing the end of net asset purchases in early July, a 25bp rate hike at the ECB meeting on 21 July, and another 25bp rate hike at the ECB September meeting. There is nothing wrong with the content of his remarks as it is exactly what we have already been expecting the ECB to do. However, if both headline and core inflation increase further in the coming weeks, a 50bp rate hike in July will still be on the table.

Bank of England

Markets continue to price in at least another six rate hikes over the next year, in addition to the four that have already happened. That still seems like an overestimate, and in fact the Bank of England itself has said that inflation will be well below target in the medium-term if it follows through with that amount of tightening.

That said, it's clear the tightening cycle still has a bit further left to run. We already had an extra two hikes pencilled in for June and August, and we're adding an extra in for September. The combination of new government support, aimed at low-income households, and more persistent worker shortages in the jobs market, give ammunition to BoE hawks to continue hiking a bit further. By September, the Bank rate will be close to something that resembles neutral and amid ongoing concerns about growth, we suspect this is where the BoE will pause.

There's also a fair chance that the Bank commences active bond sales later this year, though it really depends on whether market conditions improve. The incentive to start selling gilts is clear: without it, the Bank's balance sheet is going to take a long time to reduce in size, and indeed shrink below pre-Covid levels. The challenge will be to avoid amplifying future periods of market stress with quantitative tightening.

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