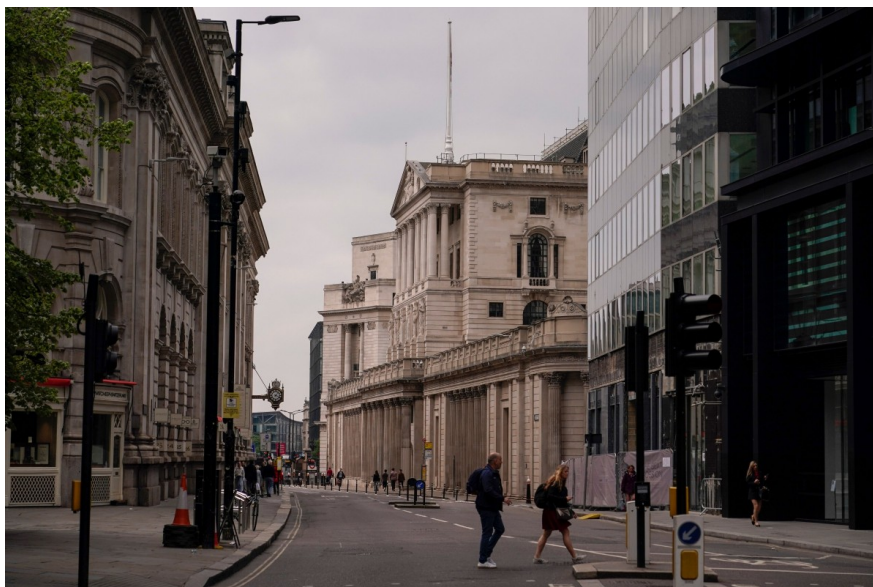


Central banks turn more hawkish as inflation concerns build

We now expect the first ECB rate hike in July, alongside successive 50 basis-point moves from the Fed, as policymakers become more nervous about inflation



The Bank of England was earlier to the rate hiking game than other central banks

Federal Reserve

The Fed shrugged off the surprise 1Q GDP contraction and hiked rates 50bp on 4 May as it looks to get a grip on inflation. Chair Powell stated that additional 50bp hikes are “on the table” for the next couple of meetings, but more aggressive 75bp moves, which the market had been contemplating, are “not something that the committee is actively considering”.

We wouldn't rule 75bp out in June given inflation is 8.5% and a tight labour market and surging employment costs risk making inflation much stickier than in previous cycles, but the Fed needs quite a lot of convincing. Either way we still see the Fed funds rate peaking above 3%.

With the Fed signaling a willingness to move interest rates quickly into restrictive territory to control inflation there is the corresponding risk of a more pronounced weakening in activity. If geopolitical tensions and supply chain strains then ease and inflation starts to fall more rapidly we could see the Fed moving back to a more neutral position in 2023.

Between 1970 and 2000 the average length of time between the last rate hike in a cycle and the first rate cut was only three months. Over the past 20 years, it has been three quarters. We are currently looking for a 1Q 2023 peak in the Fed funds rate with policy starting to be eased again from 4Q 2023.

European Central Bank (ECB)

There are several reasons why we now think that the ECB will hike earlier:

1. Comments since the last official ECB meeting have been more hawkish than the tone at the meeting
2. There has been radio silence by the doves
3. The hawks seem to be afraid that the window to actually normalise is closing fast
4. The weaker euro should lead to higher inflation forecasts for 2023
5. The July ECB meeting will be late in the month (21 July) which gives the ECB ample room between an end to net asset purchases (QE) and the first rate hike.

Consequently, we now expect the ECB to hike rates in July and September to bring the era of negative deposit rates to an end. Potentially, there could be a third rate hike in December, though this runs the risk of becoming an ex-post policy mistake.

Obviously, all of this is highly contingent on further developments with the Ukraine war and potential bans or embargos of Russian oil and gas delivery. A severe slowdown of the economy until the 9 June meeting could still change the ECB's mind.

While there seems to be broad consensus within the ECB to end net QE and negative rates, there is no consensus at all on what to do beyond this policy normalisation. We don't think that ECB members from Southern European countries will favour additional hikes in 2023 as government debt is on the rise, bond yields have already increased, and the recovery will be fragile. Also, while headline inflation is expected to come down, higher energy and commodity prices are increasingly disinflationary, wage growth will not exceed 3% year-on-year, and the Fed is expected to start easing again. So, after this year's rate hikes, we stick to the call of no further hikes in 2023.

Bank of England (BoE)

The Bank of England has now hiked four times, but the latest policy announcement contained various hints that a pause in the tightening cycle is drawing nearer. The Bank's new forecasts – while pointing to double-digit inflation later this year – show CPI below target at the three-year horizon. These projections, which are based on market rate hike expectations, can be read as a sign that the committee thinks investors are pricing in too much tightening over the next year. Before the meeting, investors were expecting a rate rise at every meeting this year, though this has since been pared back.

That's not to say the Bank is quite done with its rate hike cycle. Policymakers are clearly divided, and three voters opted for a 50bp move this time. It's clear that the committee is divided on just how concerned it should be about the tight jobs market, faster wage growth and elevated consumer inflation expectations. We'd already penciled in another rate rise for June and we suspect on the basis of May's split decision, another one could follow in August, but that's probably it.

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