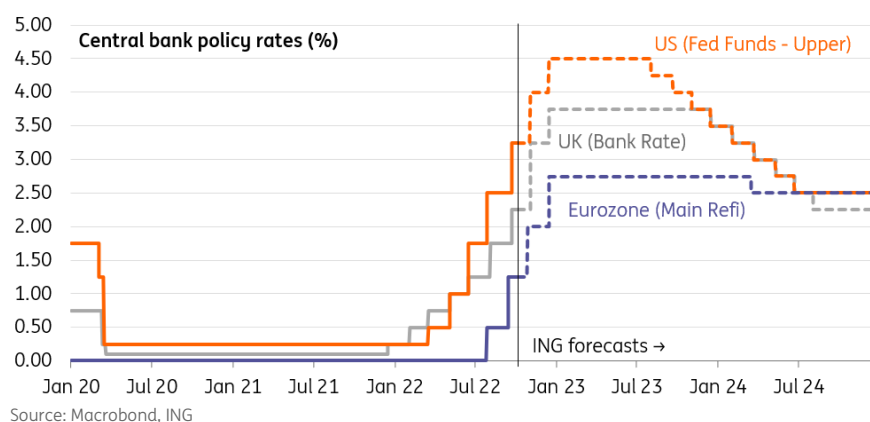


Central banks: what next from the Fed, ECB and Bank of England?

The Federal Reserve is closing in on the end of its tightening cycle as the European Central bank gets started. The Bank of England could hike by 100bp in November but is likely to undershoot market expectations thereafter



ING's latest central bank forecasts



Federal Reserve

The Fed's belated attempts to get a grip on inflation have resulted in the most rapid and aggressive interest rate increases since the 1980s. Borrowing costs are surging throughout the economy and are already causing significant pain, particularly in the housing market which has just posted the first monthly price fall in more than 10 years in the wake of plunging mortgage applications and rising supply.

Construction activity is already capitulating while the cost-of-living crisis and plunging equity and bond markets and a softening housing market are set to weigh more intensely on consumer spending in the months ahead. At the same time, businesses are becoming more cautious with survey evidence suggesting corporate investment plans are being scaled back and a growing proportion of companies are freezing hiring plans. Nonetheless, inflation pressures are lingering with core (excluding food and energy rates) rising once again. As such, we favour a fourth consecutive 75bp hike in November, but we expect a more muted 50bp hike in December given the weakening backdrop.

We are increasingly convinced that the US will experience substantial falls in inflation in 2023. Used car auction prices are down 15% while falling home prices are set to intensify and will drag down the key shelter components within inflation in the second half of the year. Surveys of corporate price plans have weakened markedly, energy costs are lower and recessionary forces will only intensify these trends. This should allow the Fed to pivot to rate cuts in the second half of 2023.

European Central Bank

Since the late summer and probably marked by Isabel Schnabel's Jackson Hole speech, the ECB's reaction function has clearly and drastically changed. Following in the Fed's footsteps, the ECB has increasingly focused on actual inflation and, to a lesser extent, inflation expectations.

What started off as a gradual normalisation process has become a hardcore fight against actual inflation. Not too long ago, the ECB's forward guidance hinted at no rate hikes in 2022, or only a 25bp rate hike in July. It's all history. With eurozone inflation at 10%, it is hard to see how the ECB cannot move again by 75bp at the October meeting. In this context, the discussion on whether or not the ECB can actually bring down actual headline inflation is no longer relevant for the ECB.

Even an increasingly unfolding recession is not enough to slow down the ECB. It clearly is an experiment with a risk of turning into a policy mistake, particularly if the economy falters much more than the ECB currently expects, but for the time being the central bank looks fully determined to continue on the path of aggressive rate hikes.

The first real test of how sustainable the consensus within the ECB is will only come at the December meeting. A new round of staff projections is likely to show further downward revisions to growth and could show 2025 inflation at 2%, tempting some of the newly self-declared tough inflation fighters to blink. However, we currently see the ECB hiking by another 50bp in December and 25bp in February 2023. We sense that it would like to go even further but we fear that the recession could be nasty enough to even second-guess the February hike.

Bank of England

Markets are expecting a lot from the Bank of England over the coming months. Though the

situation has calmed in recent days, investors are still pricing the Bank Rate to go above 5% by March 2023 (currently 2.25%). Over 100bp worth of hikes are priced for the November meeting alone.

That puts policymakers in a tricky position. If the Bank follows through with this amount of tightening, then there's a clear risk of turbulence for borrowers. Two-year mortgage rates are already tipping over 5%, and at the very least that's likely to see a dramatic slowdown in housing transactions.

Consumer fundamentals – be it employment or savings levels – remain solid, so it's not clear whether a material number of homeowners are pressured to sell. But at the very least, the rise in monthly repayments as consumers re-fix will take money away from other non-essential spending categories. For corporates, [previous Bank of England analysis](#) has suggested that the percentage of firms experiencing low interest coverage ratios would hit a record high should rates go north of 4%.

We therefore expect the Bank to err on the side of caution. We expect a sizable hike at the November meeting, and it's a bit of a coin toss between 75bp and 100bp (we've pencilled in the latter). Market pricing may force the BoE's hand, and we know the hawks are worried about sterling weakness.

But the committee is undeniably divided, and the newest member – Swati Dhingra – voted for just 25bp at the most recent September meeting. Even if the Bank does hike by 100bp next month, subsequent tightening is likely to be less aggressive. We expect the Bank Rate to peak a little below 4% in December.

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