

Deciphering the cycle

Financial markets still think this is a textbook economic cycle. But central bankers are increasingly doubtful



Carsten: Deciphering the cycle

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More than four years after the start of the pandemic, and more than two years since the start of the Russian invasion of Ukraine, the global economy is still far from normal and continues to search for a new balance.

In terms of inflation and monetary policy, the last four years look like a typical textbook cycle. Inflation surged, monetary policy reacted, inflation came down and now everyone expects monetary policy to react again and to return to normal (or neutral). However, the problem is that the last four years were anything but a textbook cycle. In fact, the global economy and, in particular, developed economies, experienced a series of unusual distortions including lockdowns, supply shocks, one-off fiscal support, pent-up demand and massive rotations in consumer spending, mismatches in job markets, and high inflation which dented spending.

Despite this long series of distortions, central banks have fought inflation in a textbook style. Whether inflation has come down by itself (and base effects) or as a result of higher interest rates remains one of the great mysteries in the current episode of global economics. What is clear, however, is the fact that higher rates will continue to weigh on economic activity and the longer they remain high, the greater the risk of an economic accident.

The problem now is that financial markets still think they are in a typical textbook economic cycle,

while central bankers seem to be increasingly doubtful. This is why markets started the year believing in imminent aggressive rate cuts and why they are now gradually pushing back their expectations. Until recently, market expectations about the next central bank steps followed the textbook models, with calls for recession coinciding with calls for a swift and aggressive monetary policy reaction. However, as long as the US stages a soft landing and the eurozone continues to see “only” anaemic growth without falling off a cliff, cutting interest rates at the current juncture will be motivated by avoiding more harm to the economy rather than reacting to a recession.

I think that it is rather unlikely that central banks will go all the way back to neutral interest rates or even below. And this not only has to do with reputational issues and inflation possibly staying more stubbornly above targets than previously thought. There are two other reasons to believe that the upcoming rate cut cycle will be more muted than before. The first is that with ongoing supply-side tensions, the risk is high that any quicker-than-expected economic recovery leads to reflation. The other factor arguing in favour of a more muted rate cut cycle is an increase in the natural interest rate. Here, the jury is still out but initial research papers point to somewhat higher natural interest rates both in the US and the eurozone. Add to that the possible positive impact of AI on productivity and hence growth and it is hard to see rates returning to pre-pandemic levels anytime soon.

Admittedly, any new era will eventually come to an end. Just as the era of “low-for-longer” came to an end, so the “not-so-low-for-longer” era will, too. High government debt and huge financing needs in many economies call for lower rates. It is impossible to tell when the mutual brotherhood of central bankers rethinks its priorities again, accepts somewhat higher inflation and puts more emphasis on growth again. But at some point, they will.

For this year, understanding and deciphering this very special atypical cycle will continue to be an enormous challenge for policymakers, markets and ourselves.

Key calls this month

United States: With GDP growth and jobs numbers beating all expectations and core inflation running too hot for comfort, 2024 market interest rate cut expectations have been pared back by 100bp since mid-January. We now expect the first cut in June.

Eurozone: Another mild winter pushing down natural gas prices is helping the eurozone economy come out of the doldrums, though 2024 growth is likely to remain subdued. With sticky services inflation and still strong wage growth, the ECB is not in a hurry to cut interest rates. We expect the first cut in June.

United Kingdom: The Bank of England will want to see the impact of annual price indexation and the National Living Wage hike in April before cutting rates. We're sticking to our call for an August rate cut.

China: While inflation gives the PBoC plenty of room to consider more policy easing, resistance to depreciation in the renminbi remaining in place will limit room for policy easing before there is a broader global environment of rate cuts. Separately, the Two Sessions will start on 4-5 March, when we expect the 2024 growth target to be set at “around 5%” again.

Central and Eastern Europe: Inflation is diverging more and more within the region, calling for a

different approach by central banks. Our baseline scenario assumes Polish rates will remain unchanged until the end of 2024, but we should see further rate cuts in Hungary, Poland and Czech Republic.

Gold: We expect gold prices to trade higher this year as safe haven demand continues to support amid geopolitical uncertainty with ongoing wars and the upcoming US election. We forecast prices to average \$2,150/oz in the fourth quarter and \$2,081/oz in 2024 on the assumption that the Fed starts cutting rates in the second quarter of the year and the dollar weakens.

FX: Our core FX view is unchanged, and we think a clearer dollar decline will start to materialise by mid-spring and accelerate into the Fed's summer rate cuts – which we expect to be much larger than expected by markets. We forecast EUR/USD to hit 1.14 by year-end as EUR and USD rates start to converge. There is good upside potential in the commodity FX space, especially in NOK, AUD and NZD.

Rates: Delivered inflation with a handle of 3% presents a problem for both US and eurozone bonds. The market is discounting a return to 2% inflation on both sides of the Atlantic, but that needs to be confirmed by realised inflation. We think that will happen, but progress has slowed. That's why market rates can remain under upward pressure for the coming month.

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