

## Our view on the major central banks

We're expecting three rate cuts from the Federal Reserve, European Central Bank and Bank of England this year



All eyes have been on ECB President Christine Lagarde this week

### Federal Reserve

The US economy has proven to be remarkably resilient to high interest rates, but there are some signs of stress. This is particularly related to lower income households who appear to have exhausted pandemic era accrued savings and are increasingly struggling to meet loan payments. Credit card and auto loan delinquencies are rising sharply while a record 10.5% of credit card balances are only receiving the minimum monthly payment. This means that debt is being rapidly accumulated at an average interest rate of 22%, with the New York Fed stating that 20% of all US credit cards are now maxed out. Given this backdrop, there is evidence of some cooling in consumer spending.

Recent inflation numbers have been better than the elevated prints seen in the first quarter, but they still remain too hot. We have had one 0.2% month-on-month reading for the core PCE deflator, but we need to see at least two more if the Federal Reserve is to realistically consider cutting interest rates. That won't happen before September, but by that time we are also expecting to see weaker labour market data based on business surveys of hiring. If the unemployment rate – which has gone from a low of 3.4% to 3.9% currently – continues to move higher and breaks clearly above 4% to, say, 4.2%, that would also incentivise the Fed to start moving interest rates from a “restrictive” position to one that is slightly less restrictive. If this is also

accompanied by a clear cooling in consumer demand, we believe the Fed will cut interest rates at the September, November and December FOMC meetings.

## European Central Bank

They did it. The European Central Bank is leading the pack of major central banks in deciding to cut its policy rates at the June meeting. In the past, rate cutting cycles were mainly triggered by either a recession or a crisis. Fortunately, neither of these are currently threatening the eurozone economy. Consequently, there was no pressing need for the ECB to cut rates or to engage in a longer series of rate cuts. Instead, the central bank cut rates not so much because it had to, but simply because it simply could. In fact, without the precommitment at the April meeting, the recent increase in wage growth and inflation would have been strong arguments against the rate cut decision.

The rate cut underlined the ECB's increased confidence in the quality of its own forecasts and an attempt to again become a forward-looking central bank and not so much a backward-looking one. Looking beyond June, we think that the path for the Bank is anything but clear, as the risk of reflation has clearly increased. The cyclical rebound in economic activity as well as structural labour shortages and upward pressure on wages could easily put the ECB's own inflation projections at risk again. We still think that the ECB currently intends to continue cutting rates this year – but the risk that the June cut was a 'one and done' deal is high.

## Bank of England

Stubborn services inflation has dramatically reduced the chances of a June rate cut in the UK, but markets have been too quick to price out easing this year. Investors are now only pricing one cut this year in November. But that goes against what Governor Andrew Bailey has been saying recently. He has been hinting that rate cuts are likely this summer and that the extent of easing this year is likely to be greater than markets are pricing. By August, the bank will have another couple of inflation readings and we think these should be less erratic. Our base case is therefore that the Bank will cut rates at that point and by a total of three times this year. Given both major political parties are signalling that they're unlikely to radically deviate from current fiscal plans in the near-term, the July election is unlikely to drastically change the BoE outlook for this year.

## Bank of Japan

The Bank of Japan is set to normalise its monetary policy, but it will take a few more data points to move in the direction it hopes for. Confirmed by the reacceleration in Tokyo CPI, inflation is expected to rise to nearly 3% in the coming months. However, the most anticipated data should be labour earnings, which are likely to jump from May as newly negotiated wage growth starts to feed through. In our view, the BoJ is likely to have data on hand to support its second rate hike by the time it meets on 31 July. There has been market speculation that the BoJ will decide to reduce JGB purchases at the June meeting – but with the 10y JGB at a multi-decade high, we think the central bank would like to wait for a better time to do so. This would probably be when the UST begins to trend lower.

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