We're still playing the central bank waiting game

We thought at the start of the year that there'd have been more rate cuts from the Federal Reserve by now. We still think things will really get going in September

ECB President, Christine Lagarde with someone who looks very like the Fed's Jay Powell. But isn't.

The half-time review

Financial markets started the year expecting six rate cuts from each major central bank. But it didn't take long for more resilient US activity data, coupled with some unwelcome news on American inflation, for investors to begin rapidly scaling back those expectations. The sheer resilience of the US economic story has given the Federal Reserve the confidence to adopt a highly data-dependent approach to timing the first rate cut.

Over in Europe, the strategy has been visibly different. Policymakers have made no secret of the fact that they are becoming more confident in their inflation predictions, in no small part because the inflation data itself has been less volatile. They've proven themselves to be less worried about the potential risk of currency depreciation as a result. All of that helps explain why the European Central Bank felt comfortable cutting rates in June, despite mixed signals from the most recent wage and CPI data and a higher for longer story across the Atlantic.

Second-half prediction: Federal Reserve

After its June update of individual member forecasts, the Federal Reserve's central tendency suggests that just one 25bp interest rate cut is seen as the most likely path forward for monetary policy amongst officials in 2024. Nonetheless, the market continues to price two cuts, which is also the consensus forecasts amongst analysts, while we still favour three cuts this year with a further three in 2025.

The Fed doesn't want to cause a recession if they can avoid it and if the data allows we expect the Federal Reserve to start moving monetary policy from "restrictive" territory to "slightly less" restrictive policy from September.

To deliver this we look for three things:

1. Core inflation to continue coming in at 0.2% month-on-month or below – the run rate required to bring annual inflation to the 2% target.
2. The unemployment rate, which has already risen from 3.4% to 4.1%, to push higher towards 4.3%.
3. Consumer spending growth, which has slowed from a 3%+ annualised rate in second half 2023 to 1.6% in the first half of 2024, to decelerate further.

Such outcomes should give the Fed confidence that the economy is on the path for a soft landing, and from there it can start to move its policy stance closer to neutral.

2 Second-half prediction: European Central Bank

This is not, yet, a typical rate cutting cycle in the eurozone. In the past, easing cycles had always been triggered by recessions or crisis. Fortunately, none of these are currently the case. Therefore, any further rate cuts will not be on autopilot. In fact, the balance between data dependency and reputational risks has become more delicate, particularly given the dissenting views at the June meeting.

The ECB won't have any interest in making the June cut look like a policy mistake over the coming weeks, which would be a strong non-economic argument in favour of another rate cut at the September meeting. At the same time, however, the weakening economic momentum and stubbornly high domestic inflation is not a combination to cheer for. It is clear that the July meeting will probably be a non-event without any new rate action or rate guidance. In fact, we expect the ECB to cut rates again at the September and December meetings – at least as long as the ECB itself continues to see inflation at 2% and below from the end of 2025 onwards.

3 Second-half prediction: Bank of England

We've long expected the Bank of England's first rate cut in August, and that looks like it is on track. Admittedly services inflation has overshot expectations over the past couple of months. But a lot of this can be traced back to annual price rises at the start of the financial year which, much like we saw in 2023, were larger than the BoE had expected. Ultimately this should be a temporary blip, and the Bank itself appeared to play down the upside surprises here in its June policy statement.

In fact, although seven out of the nine-strong committee voted to keep rates on hold last month, the meeting minutes revealed that some of them thought the decision was "finely balanced". That's central bank speak for saying a rate cut is imminent. We've not heard much from BoE officials given restrictions on speeches during the election campaign, but before that started Governor Andrew Bailey had said that the Bank could cut rates faster than markets expect. We're therefore comfortable with our call for three cuts this year, which is one more than markets are currently pricing.

4 Second-half prediction: Bank of Japan

Recent data has been mixed, but key wage data grew strongly and forward looking data points to a near-term recovery. While the Bank of Japan has ignored or underestimated the impact of the yen on inflation in the past, it has become more open and frequent in expressing concerns that the weak JPY is having a meaningful impact on inflation this time around.

Some may argue that the BoJ won't surprise markets by raising policy rates and announcing quantitative tightening at the same time. This is probably the major reason why the probability of a July rate hike remains at 58%.

However, we believe it is the right time to accelerate policy normalisation. The Bank of Japan is confident that the economy is entering a virtuous cycle – where strong wage growth supports economic growth – while remaining concerned that high inflation is damaging the economy. Moreover, the recent slowdown in US economic data makes it a good time for the BoJ to make these changes.

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