SCENARIO UPDATE: CENTRAL BANKS, INFLATION AND OIL

FROM WHATEVER IT TAKES TO WHATEVER IT BREAKS

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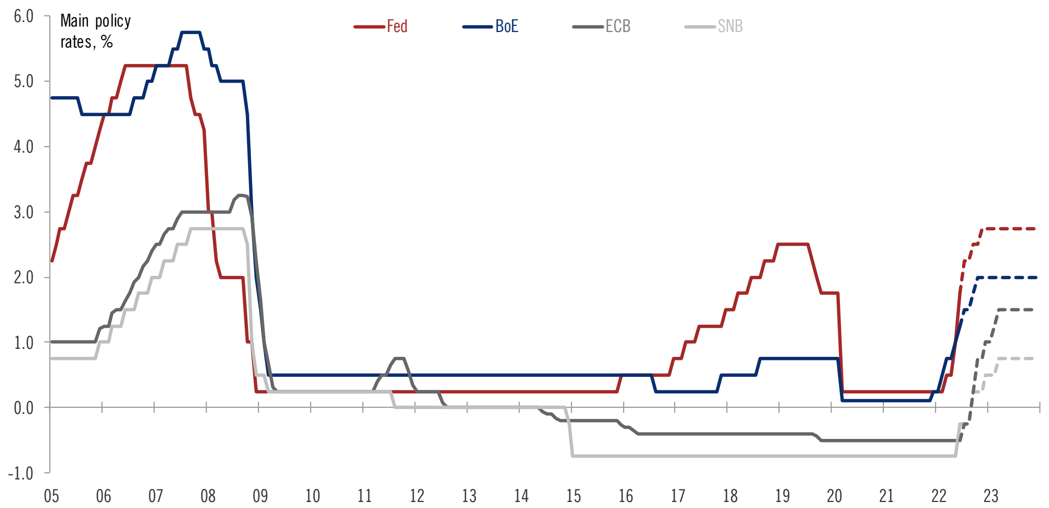
SUMMARY

- This week's announcements by major central banks suggest that their reaction function is diverging from our initial expectations, with inflation concerns trumping sensitivity about growth data and financial conditions. We are adjusting our forecasts for policy rates accordingly.
- We now expect the Fed to hike by 50bp in July, followed by 25bp hikes at each of its subsequent policy meetings (September, November, December).
- The ECB looks set to announce a new 'anti-fragmentation' tool at its July meeting, which could pave the way to accelerate monetary tightening. We expect the ECB to hike by 25bp in July (with an outside chance of 50bp), 50bp in September and in October, before slowing the pace to 25bp in December.
- Following today's surprise hike, we are also revising our policy rates profile higher for the SNB and, to a lesser extent, for the BoE.
- The BoJ is under pressure to adjust its Yield Curve Control policy, although this may take some time and currency interventions could be on the agenda.
- Lastly, we are raising our year-end target for Brent oil prices to USD110 per barrel on the back of protracted supply constraints.

CHART 1: MAIN POLICY RATES WITH PWM FORECASTS



Source: PWM – CIO Office & Macro Research, Refinitiv

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US Federal Reserve: what next after the first 75bp rate hike since 1994?

We are changing our Fed call following the 15 June Federal Open Market Committee (FOMC) meeting. The Fed's reaction function is diverging from our initial expectations, with the central bank still showing limited sensitivity to deteriorating growth data and financial conditions. We are in a "mini-Volcker, panicky-Fed" moment, with the Fed's actions driven first and foremost by headline inflation, including fuel and food prices.

We now foresee a hike of 50bp in the fed funds rate at the next FOMC meeting in July, followed by 25bp increases at each of the subsequent meetings (September, November and December). This would put the fed funds rate in a range of 2.75-3.0% by end-2022. This would still be below the 3.4% median for December 2022 shown in the updated Fed 'dot plot' forecast, as we think growth data will come in lower than the Fed expects in the coming months—in fact, we expect GDP growth of only 1.0% on average in the second half of the year, with a mild recession starting in early 2023. Signs of a broad-based slowdown in growth, and particularly non-farm payrolls, should eventually mean the Fed pauses its rate hikes, in our view. We expect the rise in the headline consumer price index (CPI) to stabilise over the next few months at 8.0-8.5% year-on-year (y-o-y) before declining closer to 5% by year's end. We forecast core personal consumer expenditures (PCE) inflation (the Fed's favoured inflation gauge) to be close to 4% at the end of 2022.

There is the possibility the Fed tightens more than we expect in this updated scenario (for example, it could opt for another 75bp hike in July, with 50bp hikes per meeting thereafter). CPI (and particularly food and fuel prices), wage growth and inflation expectations (including consumer-driven inflation expectations contained in the University of Michigan survey) will all be crucial to watch.

ECB: a new backstop instrument in July, and faster rate hikes from September

Recent oil price movements and May's upside surprise in headline inflation mean we are revising our inflation forecast for the euro area, expecting price rises to peak in late Q3. More importantly, we now expect core inflation to rise above 4% before easing somewhat in Q4. Our forecast for sustained inflation pressure in the coming months reflects the effects of supply bottlenecks, strong demand for contact-intensive services (particularly tourism-related items) and the indirect effects of the surge in energy prices.

This week, the ECB tried to assure bond markets by saying it would adopt a flexible approach to reinvesting the proceeds from its Pandemic Emergency Purchase Programme (PEPP), and that it had tasked the relevant committees "to accelerate the completion of the design of a new anti-fragmentation instrument".

The devil will be in the details, but we believe that the ECB will have no choice but to deliver on these promises. **This should allow it to accelerate the pace of rate hikes. We expect the ECB to hike by 25bp in July, 50bp in September, 50bp in October, then 25bp in December, February, March**, pushing the terminal rate to 1.5% by Q1 2023. We then expect the ECB to pause on the back of weaker growth and inflation in 2023.

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There is a possibility of higher rate hikes in the near term (with an outside chance of a 50bp hike in the deposit rate in July), but also a chance that the ECB's rate-hiking campaign stops earlier than has been expected.

The ECB's capacity in terms of flexible PEPP reinvestments is not insignificant, but probably falls short of the support needed in case of severe financial fragmentation. Indeed, we estimate that the ECB could front-load up to €10bn in PEPP reinvestments per month that could be redirected to the periphery before a new tool is deployed. A possible game-changer would see the ECB abandon the objective to converge back to capital keys in terms of PEPP holdings over the medium-term, freeing up additional capacity for core bonds redemptions to be reinvested in peripheral markets, but that may be hard to sell.

We expect a new anti-fragmentation tool to be announced at the 21 July meeting of the Governing Council. Our best guess is that the new backstop will resemble the Outright Monetary Transactions (OMT) instrument, but with some differences. Ideally, the new tool would have no ex ante limit on the total amount of purchases and, crucially, no consolidation of holdings with other asset purchase programmes to avoid any constraints linked to issuer limits. It would benefit from full flexibility in terms of allocation of purchases across time and jurisdictions. Also, the facility would include light conditionality based on member states' compliance with European Commission's recommendations under the European semester, essentially making any compliant country eligible to ECB purchases. Finally, the ECB may add some 'safeguards' by focusing on shorter maturities than under the PEPP but longer than under the OMT, say 2 to 5-year maturities, to be consistent with the ECB's focus on monetary policy transmission. The purchases may be sterilised using ad hoc facilities or the issuance of ECB debt certificates. ECB 'sources' have suggested that the ECB could sell other securities including German bonds in order to neutralise the effect of additional asset purchases on excess liquidity. While the political argument sounds compelling, the risk would be to push all bond yields much higher in a disorderly fashion.

Last but not least, it remains to be seen whether the ECB will ultimately disclose the criteria defining 'fragmentation' and the yield spread levels that justify interventions; in other words, how it distinguishes 'orderly' spread movements from 'disorderly' ones. We suspect they will remain vague about that.

Bank of England: less aggressive after all

We are raising our expectations for the Bank of England (BOE) benchmark rate, which we now expect to peak at 2.0% by November 2022. After today's 25bp rise in the bank rate, we forecast additional rate increases of 25bps at each of the BOE's next three meetings.

The BOE started hiking earlier than other major central banks, but it has shown itself to be more sensitive to growth data than others. Given the challenging growth backdrop facing the UK economy, the bank rate could plateau sooner. Monthly GDP for the UK has been especially weak of late, coming in at -0.3% in April, -0.1% in March and 0.0% in February.

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SNB: we expect another bold move in September

The Swiss National Bank (SNB) raised its policy rate by 50bps to -0.25% on 16 June. This is its first interest rate hike since 2007 and precedes the expected ECB rate hike in July. Three factors probably pushed the SNB to act so boldly: first, the 75bp rate hike announced the previous day by the Fed; second, the likelihood the ECB introduces a new backstop instrument in July to prevent financial fragmentation (which could enable the ECB to hike rates faster); and third, recent currency market developments. The SNB said the rise in rates was aimed at "preventing inflation from spreading more broadly to goods and services".

The SNB revised substantially its conditional inflation forecasts to 2.8% (from 2.1%) for 2022, 1.9% (from 0.9%) for 2023, and 1.6% (from 0.9%) for 2024. **We now see the SNB hiking its policy rate by 50bp in September and then by 25bp at each quarterly meeting until at least March 2023, bringing it up to at least +0.75%**. Risks are tilted towards bolder moves, depending on the exchange rate and policy actions by other central banks. The SNB is now actively considering quantitative tightening (QT, i.e.. actively reducing its balance sheet), although we feel the conditions are still not right for the SNB to sell its currency reserves at this stage.

BOJ: under growing pressure

The Bank of Japan (BoJ) is caught in a very awkward position. On the one hand, Japan's domestic economic conditions suggest that the BoJ still has reasons to stick to its ultra-loose monetary policy. After all, there is little (if any) pressure on inflation from domestic demand. Consumption has just started to recover, but at a moderate pace. The labour market is recovering too, but wage growth remains muted. And Japanese export growth is clearly slowing on weakening external demand, particularly from China.

On the other hand, the divergence between its monetary policies and the Fed's means the BoJ is under strong pressure on the currency front. Since early March, the yen has depreciated by about 15% against the US dollar, dropping to 135 yen per dollar at one point, its lowest level since 1997. By contributing to the surge in energy and food prices, the yen's weakness has become a source of public disquiet and a sensitive political issue. For the first time during his tenure as governor of the BoJ, Haruhiko Kuroda has had to admit recently that the sharp yen depreciation is bad for the overall economy.

In our view, **there is a rising chance for some adjustment in the BoJ's policy over the next few months**. One possible change could be to move the anchor point of its yield curve control (YCC) to a shorter maturity (for example, moving from fixing the 10-year JGB yield to fixing the 5-year one, thus allowing long-term yields to move higher).

Another near-term option would be direct interventions in the FX market. This would be a decision for the Ministry of Finance, but it would be implemented by the BoJ. Some Japanese government officials have recently started to warn against further sharp depreciation of the yen and hinted at possible intervention. While the timing of such interventions is difficult to predict, one likely will need to see much more frequent and urgent verbal warnings before any real action is taken.

Oil: hot summer ahead

Tension in the oil market is likely to persist during the northern hemisphere summer. Russian oil supply is missing from the equation, notably refined products. At 91%, US refiners are producing at close to their maximum capacity. At the same time, US demand is back to pre-pandemic levels and the summer driving season is likely to ensure demand stays high. Petrol prices at the pump have reached USD5 per gallon for the first time since 2004 (compared to USD2.6 in December 2019). Prices could increase further during July and August, conceivably rising above USD6 per gallon.

Forward demand remains high for crude oil. The Brent futures curve shows massive backwardation (USD119/barrel in two months, USD95 by end 2023). This situation is likely to prevail during the summer.

Global supply elasticity remains limited. US shale oil production is back to its all-time high of 9.4 million barrels per day (mbd). Further expansion will require increased investment. The OPEC+ quota system ends in September. If the market tightens too much, we could see Saudi Arabia and UAE increase supply to compensate for Russian oil and the inability of other members to meet their production quotas.

Two main opposing forces will determine global oil demand. The first is the expected slowdown in Western economies in H2 due to the energy shock and tighter financial conditions. The second is China reopening, which could boost commodity demand after the downturn in demand caused by China's zero-covid policy. These two opposing forces will determine whether the oil market remains in slight oversupply (as it has been in the past three months) or falls back into undersupply. All things considered, we have raised our forecast for Brent oil price, which we expect to remain at USD120-USD130 per barrel during the summer. **We then expect prices to settle at USD110 by the end of the year** (compared to our previous forecast of USD95).

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