PICTET 1805

PICTET WEALTH MANAGEMENT

Central banks: slightly higher for even longer

Monetary policy is lost in transmission

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FLASH NOTE

05.07.2023, CIO OFFICE & MACRO RESEARCH

SUMMARY

- Central banks may have to threaten hikes to secure 'higher for longer' baseline.
- We now see a final Fed hike of 25bp in July.
- ECB looks certain to hike in July, and we now expect a final 25bp hike in September although it is a closer call than most observers believe.
- We expect the BoE to hike further to restore credibility, although we do not think they will deliver as much tightening as markets expect.
- We forecast a final SNB hike of 25bp in September.

CENTRAL BANKS HAVE A LICENCE TO LIE

For all their differences, central banks have been guiding markets, companies, and households to expect higher policy rates for longer – a more "persistent" response to more persistent inflation. While higher rates come with costs and risks, central banks insist that the alternative would be much worse. If higher inflation became entrenched, they would have to raise rates even more, causing greater pain in the economy.

One key source of uncertainty facing central banks – and an important difference across countries – has come from the **unusual lags in the transmission of monetary policy to the real economy**. In short, the transmission has been slower, and possibly less effective so far in the US than in the euro area, for a variety of reasons including a shallower increase in bank deposit and lending rates, but also the relative stability in long bond yields and mortgage rates in the US. In the euro area, where the banking sector did not "break", the tightening of credit conditions and the effective slowdown in bank lending has been more pronounced than in the US, at least initially. At the same time, the energy shock has hit Europe more strongly, and inflation has been stickier on this side of the Atlantic.

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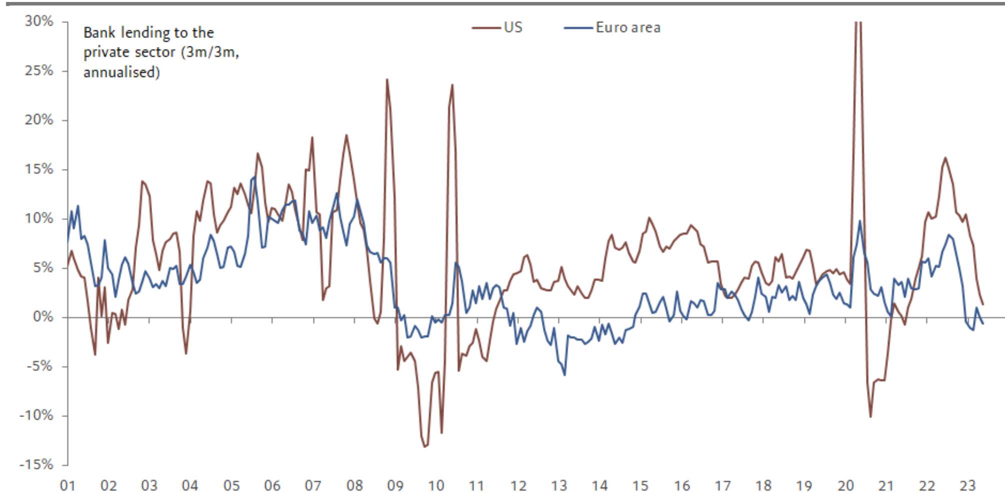
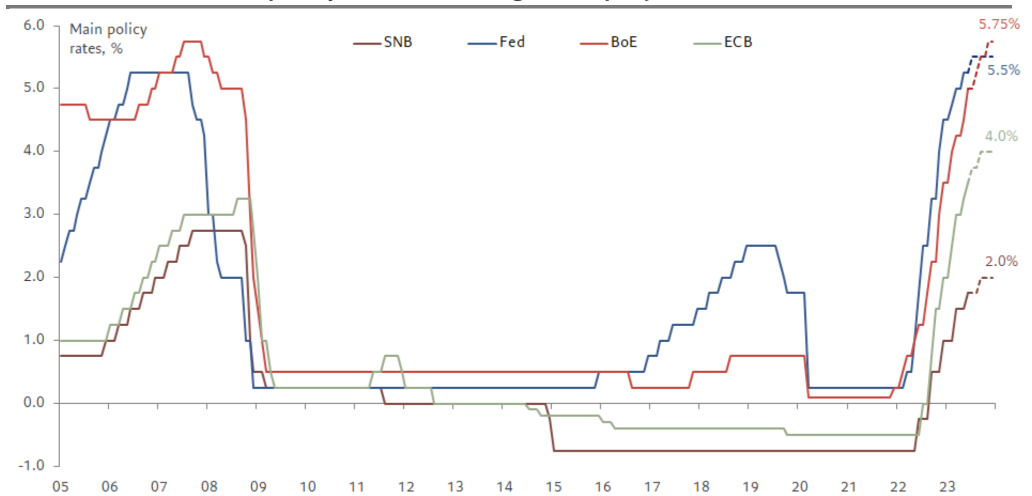
Chart 1: bank lending to the private sector in the US and the euro area



Source: Federal reserve, ECB, as of 5 July 2023

A faster transmission of monetary policy implies that the ECB might have to hike less, all else being equal, to achieve the same degree of tightening. Both the ECB and the Fed will likely resist rate cuts for as long as possible, until they are reasonably confident that inflation will return to the 2% target. A sharper economic slowdown would make them more cautious, but we believe that **the bar to deviate from the 'higher for longer' mantra is very high**.

Chart 2: central bank policy rates including PWM projections



Source: Pictet Wealth Management, Fed, ECB, BoE, SNB, as of 5 July 2023

In order to push back against rate cuts expectations, central bankers may have to lie, and keep threatening to hike rates even when they become more confident over the inflation outlook. Meanwhile they will try and hide any internal disagreements over the appropriate policy stance. This may explain why central banks' communication has been somewhat confused lately. The Fed added two interest rate hikes to their dot plots, but they neither hiked in June nor committed to a July hike. The ECB and the SNB raised rates in June, but the upward revisions to their inflation projections were surprisingly large.

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Central banks will remain data dependent, but it is possible that they overplay their hawkish stance as a communication trick to secure a 'higher for longer' baseline.

FED: A FINAL HIKE DESPITE ENCOURAGING INFLATION MOMENTUM

The FOMC kept rates unchanged in June, but the dot plot showed a majority of officials see 50bp or more of tightening by year end. **We now expect one more 25bp increase in July to bring the fed funds rate to 5.25-5.50%.** As rates inch further into restrictive territory, Chair Powell has stressed the need to moderate the pace of hikes in order to better assess lags of monetary policy and any impact from credit tightening.

In our view, **the hurdle is relatively high for another rate pause in July**. There is only one employment and one CPI report before the 26 July FOMC meeting. Unless data surprise significantly to the downside, economic resilience so far and above-target inflation support another move higher in rates, which has been largely priced by the markets.

Looking beyond July, we expect signs of further disinflation and an economic slowdown to lead to an extended pause by the FOMC. Although the dot plot signals more tightening, Chair Powell refuses to commit to future policy decisions. He wouldn't rule out rate hikes at consecutive meetings, or at every other meeting. We expect the Fed to be extremely data dependent and the data to deliver a pause.

However, a hawkish bias remains. The Fed needs to keep policy rates and financial conditions tight to battle inflation, so implicitly it has to keep a hawkish bias to prevent the markets from pricing in aggressive rate cuts. Moreover, risks are skewed to the upside for both growth and inflation, and we wouldn't rule out another increase in September or November.

We still do not expect rate cuts this year. Policy is likely to remain restrictive for a while after reaching peak rate. Importantly, when the Fed eventually starts cutting rates, we expect the decision to be primarily driven by falling inflation. As inflation falls, the *nominal* policy rate would need to decline to maintain the same level of monetary tightening measured in *real* rates. Unless the economy enters into a sharp downturn with a significant increase in the unemployment rate, **we see a terminal rate in a cutting cycle above the Fed's neutral rate estimate of 2.5%.**

We still do not expect changes to quantitative tightening this year. Risks are skewed towards an early end given the increase in T-bill issuance, but so far bank reserves have declined little as money markets absorbed the majority of the supply.

ECB: PERSISTENCE BUT NO OVERTIGHTENING

The ECB raised interest rates by 25bp at its June meeting, bringing its deposit rate to 3.5%, while signalling that it has still "more ground to cover". The ECB committed to maintaining a tight policy stance for as long as necessary in order to achieve "a timely return of inflation to the 2% medium-term target."

ECB President Lagarde said that "the second phase of the inflation process is now starting to become stronger", largely due to a "sustained wage catch-up process". A tight labour market is slowing down the disinflation process. As such, the recent weakening in leading activity indicators is unlikely to stop the ECB. Last but not

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least, the ECB believes that demand needs to be damped for longer "so that firms cannot continue to display the pricing behaviour we have recently seen".

In all, the ECB looks set to hike in July, but another move in September is less certain. The hawks have argued that core inflation needs to be "firmly in retreat" before the ECB can pause. That is unlikely to be the case by September as we forecast core inflation to remain elevated and volatile throughout the summer. A September hike is not a done deal either as inflation momentum has been slowing, potentially leading to a downward revision to staff projections in September. Either way, we believe that **a September hike would be the last one in this cycle, bringing the deposit rate to 4%**. Crucially, the ECB will then focus on the necessity to keep rates at these levels for longer, and we expect no rate cut before H2 2024.

BOE: MORE HIKES TO RESTORE CREDIBILITY

The Bank of England (BoE) surprised markets by hiking rates by 50bp in June, to 5%, in a "forceful" decision justified by the "material news" in the CPI and wage data. In response to higher inflation, the BoE felt they had no choice but to front-load rate hikes in order to retain some credibility, while signalling more to come.

We now expect the BoE to hike rates by another 50bp in August, followed by a final 25bp move in September, bringing the Bank rate to 5.75%. However, risks look more symmetric now, and we keep a terminal rate forecast below market forwards. First, it is still possible that the BoE hikes by 25bp only in August, if core inflation and wage growth ease by then. Second, we expect the economy to weaken further as the impact of higher rates broadens. The BoE itself believes that higher rates will continue to feed through the economy and the mortgage market, in particular. The longer lags may be due to "the higher share of fixed-rate mortgages", but the transmission is still working, with more weakening on the cards.

On inflation, the BoE acknowledged the improvement in leading indicators, including producer prices, but the much bigger worry is that second round effects on wages could "take longer to unwind than they did to emerge". Still, even the BoE reckons that "some indicators of future pay growth have weakened".

SNB: A FINAL HIKE IN SEPTEMBER

The Swiss National Bank (SNB) increased its policy rate by 25bp at its June meeting. The latest rise brings the SNB's main policy rate up to 1.75%. Despite inflation figures surprising to the downside for the last few months, comments were rather hawkish about the (medium term) inflation outlook. In particular, inflation forecasts were revised up for 2024 and 2025. The reasons for this are the ongoing second-round effects, higher electricity prices and rents, and more persistent inflationary pressure from abroad. Of particular concern is the expected rise in rents, which account for 18.6% of the consumer basket and are indexed to interest rates.

The new SNB forecast puts average annual (headline) inflation at 2.2% for 2023 and 2024, and 2.1% for 2025. With inflation still expected to be above its definition of price stability in Q1 2026 (the last data point), the SNB is signalling that more tightening may be warranted. **We therefore expect a final rate hike of 25bp in September, bringing the policy rate to 2.0%** (see "The Swiss outperformer" for details on the macro outlook).

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