Central banks' hawkish downshift

We expect central banks to slow the pace of tightening but hint at higher terminal rates

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FLASH NOTE

SUMMARY

- Major central banks meeting next week each face different macroeconomic conditions but a similar challenge. They will need to balance the need for a more gradual approach, following one of the fastest monetary tightening cycles in history, with lingering inflation risks, including concerns over wage growth and second-round effects.
- We expect the Federal Reserve (Fed), the European Central Bank (ECB), the Bank of England (BoE) and the Swiss National Bank (SNB) to hike their policy rates by 50 basis points next week. Their communications should remain hawkish, consistent with higher terminal rates and no early rate cuts.
- The Fed will likely highlight the risk a still-tight labour market fuels a wage-price spiral. The ECB will express similar concerns over wage growth and present the broad principles of its plans for quantitative tightening. The BoE looks likely to prioritise the fight against inflation over economic pain even though the UK economy has likely entered recession already. The SNB is not done yet with its hiking journey despite lower inflation than in other countries and it will likely signal that it is too early to let the Swiss franc weaken.

FEDERAL RESERVE: SHIFTING DOWN TO 50BPS AIN'T NO TRUE PIVOT

On 14 December, we expect the Fed to raise rates by 50bps (in line with market consensus), a smaller increment than the +75bps rises at previous meetings. This should push the fed funds target range to 4.25-4.50%.

We expect communication to stay hawkish as we do not think Fed chairman Jerome Powell will lower his guard on inflation risks. Powell is anxious about labour-market driven inflation, and recent data could keep him on high alert: November's payroll growth remained robust at 263,000, while the unemployment rate was still rock bottom at 3.7% (the same as in October). Wage growth surprised in November, with average hourly earnings accelerating to 5.1% year-on-year.

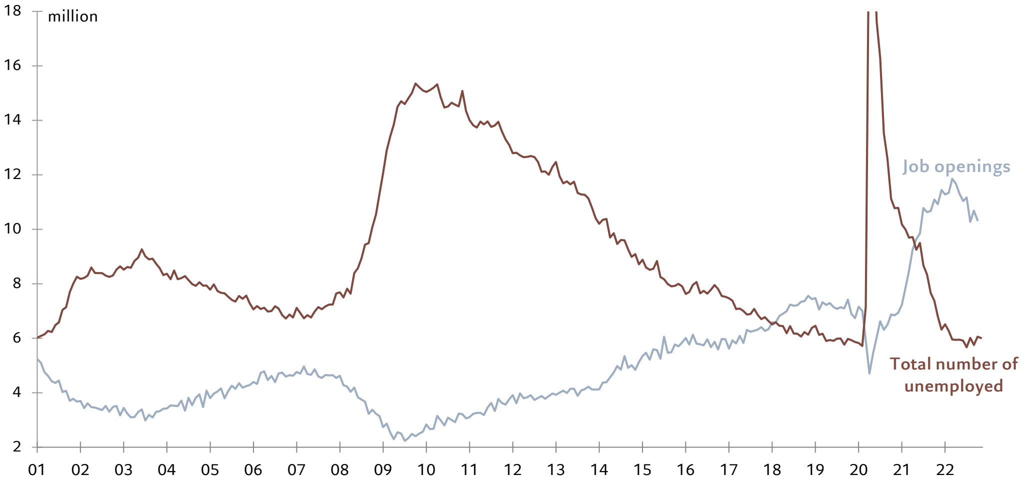
Meanwhile, job openings are slowing, but only very gradually and the job openings to unemployed ratio (a key metric on Powell's radar screen) is still elevated at 1.7x.

At next week's Federal Open Market Committee meeting, the focus will be on the 'dot plot' of macroeconomic and interest rates projections. Powell highlighted in his most recent speech that the terminal rate may be revised "somewhat higher" from the forecast of 4.6% made in September. But some regional Fed members such as the St Louis Fed's James Bullard have hinted that the upward revision would have to be more aggressive given the tightness of the labour market. Overall, **we expect the Fed's terminal rate to be revised up to around 5.1%, which would also be consistent with our view of a terminal rate of 5.0-5.25% by March 2023**.

By hiking rates again, the Fed will step away from its longstanding tradition of watching the yield curve (now indicating a recession is around the corner) and forward-looking manufacturing sentiment (the ISM survey dropped into contraction territory in November), thus suggesting it remains focused heavily on the inflation side of its dual mandate.

In conclusion, we do not think the Fed is ready to announce yet the end of its rate-hiking cycle as it still worries about labour market tightness and services inflation's resilience, even though goods and commodity price rises continue to slow. Powell is likely to drive home the point that the bar to cutting rates will be high in 2023 given the high current level of inflation (the headline CPI was 7.7% year-on-year in October). Keeping a restrictive stance for longer would go against current market pricing of a slide in the fed funds rate to around 4.5% by end 2023.

Chart 1: The US labour market is very tight as job vacancies outstrip unemployment



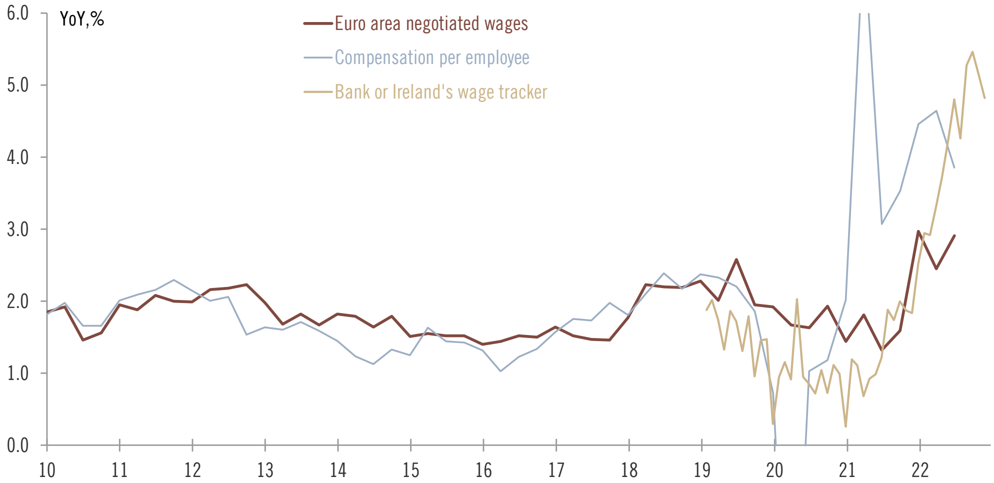
Source: Pictet WM CIO Office & Macro Research, Factset, 9 December 2022

EUROPEAN CENTRAL BANK: HAWKISH 50BPS HIKE ALONG WITH QT PRINCIPLES

We expect the ECB to hike its policy rates by 50bps at its 15 December meeting, following two consecutive 75bps hikes. **This would bring the deposit rate to 2%, close to the estimated neutral rate**. Our forecast for 2023 is for the ECB to deliver two additional 25bps hikes in February and in March, with upside risks.

There are many arguments for the ECB to slow the pace of tightening. Euro area inflation eased in November, surprising to the downside for the first time in almost two years. Meanwhile, economic activity has remained somewhat resilient going into winter (but a mild recession is likely to become the new baseline in ECB staff's December projections). More importantly, several Governing Council members have stressed the need for a more gradual approach following the 200bps of cumulative tightening delivered since July and the lags before tighter financial conditions affect the economy. Wage growth has become a key source of concern, although the latest round of wage negotiations in Germany did not result in unsustainable pay rises and recent data for the euro area are not pointing to very large increases either (including the Bank of Ireland's wage tracker, *see Chart 2*).

Chart 2: measures of euro area wage growth



Source: Pictet WM CIO Office & Macro Research, ECB, Bank of Ireland, 9 December 2022

The ECB's downshift is likely to be counterbalanced with hawkish communication. In particular, the new staff projections will include **the 2025 outlook** for the first time, and inflation is likely to remain at, or slightly above the 2% target over this time horizon, suggesting that more rate hikes will be needed. At a minimum, President Christine Lagarde should lean against the idea of a pause any time soon.

We only expect the broad outlines of the ECB's plans for quantitative easing (QT) to be unveiled next week. Our assumption remains that the ECB will try to keep QT gradual and predictable in order to mitigate market disruptions. We don't expect the ECB to sell debt securities outright. Instead, it should stop reinvestments of maturing bonds under the Asset Purchase Programme (APP)—but not the Pandemic Emergency Purchase Programme (PEPP), which could still be used to address the risk of financial fragmentation if needed.

The prospect of larger bond issuance in Q1 suggests that the ECB could start QT at the beginning of Q2. **We expect the ECB to reduce its APP holdings by an average of EUR20 bn per month**, although it could do so in many different ways. For example, the ECB could introduce so-called caps on reinvestments (up to which the ECB will stop reinvesting the proceeds of maturating securities) and gradually adjust these caps higher. This would raise some technical questions about the bonds to be reinvested in excess of the caps across markets and jurisdictions. Another option would be for the ECB to target a certain level of balance sheet reduction per

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quarter and to retain some flexibility in terms of the modalities of QT. But the risk is that markets are disappointed by the lack of details next week.

BANK OF ENGLAND: ANOTHER 50BPS FOR THE ROAD

On 15 December, we expect the BoE to hike rates by 50bps, pushing the bank rate to 3.5%. Inflation remains the main thorn in the BoE's side. While consumer inflation may have (finally) peaked in year-on-year terms in October at 11.1%, the descent is likely to be very gradual, removing any temptation for the BoE to celebrate.

The day before the policy meeting, the November's consumer price index is expected to come in at a still-high 10.8% y-o-y. The BoE has long mentioned its worries that a recession will create an "output gap" and ultimately feed into disinflation. Yet a trail of high inflation reports is still keeping the Bank firmly fixed on the present. Meanwhile, the UK labour market remains resilient, although this resilience may be due to supply-side problems just as much as strong underlying demand for workers. Still, the October unemployment rate was still very low at 3.6% so that the BoE, like the Fed, may continue to worry about wage growth feeding into services inflation (i.e. 'second round effects').

We continue to think that the Bank of England could end up hiking interest rates to 4.75% by May, especially given the risk of another inflation shock from the April 2023 utility bills hike. The market is currently pricing a bank rate of around 4.5% by June 2023.

Chart 3: Inflation expectations remain high, which could keep the BoE anxious

Source: Pictet WM CIO Office & Macro Research, Factset, Bank of England, 9 December 2022

SWISS NATIONAL BANK: TOO EARLY TO CLAIM VICTORY

Price pressures have eased somewhat in Switzerland, reducing the need for further aggressive monetary policy tightening. Following rate hikes of 50bps in June and 75bps in September, **we expect the SNB to slow the pace of hiking at its December meeting and raise its main policy rate by 50bps to 1.0%**. The language in the policy statement is expected to remain fairly unchanged from September. The SNB

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is likely to keep open the possibility of further rate hikes at coming meetings and underline its willingness to intervene in the foreign exchange market "as necessary" to "provide appropriate monetary conditions".

While we think a 50bps hike is the most likely outcome next week, we do not exclude the possibility of a higher or lower rate increase. On the one hand, the SNB's policy decision will come after the Fed's but a few hours earlier than that of the ECB, which we expect to hike by 50bps (see above). Even if not our base case, more aggressive tightening by the ECB cannot be ruled out. The SNB could opt for a more hawkish rate increase of 75bps, particularly if it is more worried than assumed about medium-term inflation pressures and wants to strengthen the Swiss franc. On the other hand, the recent correction in energy prices and the slowdown in global economic activity could lessen SNB concerns about inflation and persuade it to go for a 25bps hike.

At the news conference to announce next week's rate decision, the focus will probably be on the SNB's balance sheet following the publication of interim results showing the central bank made a loss of CHF 142.4 bn for the first three quarters of 2022. SNB chairman Thomas Jordan is likely to stress that the SNB's mandate is to ensure price stability (defined as a rise in consumer prices of less than 2% per annum) and that losses on its balance sheet are secondary. Furthermore, while rates remain the policy tool of choice at the moment, the SNB will continue to keep the door open to selling foreign currency if the Swiss franc were to weaken.

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