June 4, 2024

Central Bank Policy Divergence

The latest bout of commentary from Federal Reserve (Fed) members reiterated not just the Fed's broader message of patience, but offered a clearer indication of how many more months of improved data are needed to justify a rate reduction.

While maintaining a bias towards eventual rate reductions, it appears that *"eventually"* will more likely be a 2025 event. Furthermore, while the Fed remains optimistic that disinflation will more clearly re-emerge in the coming months, particularly as shelter costs are expected to improve, on the contrary, some Fed members have vocalized an openness to *raising* rates if inflation fails to evolve as expected.

Minneapolis Fed President Neel Kashkari, for example, reiterated a need for the Fed to remain patient with policy on the sideline as the broader economy remains solid and inflation stubbornly elevated. Speaking to CNBC early Tuesday morning, he said, *"Many more months of positive inflation data, I think, [are needed] to give me confidence that it's appropriate to dial back [policy]."*

Meanwhile, the Federal Open Market Committee minutes from the meeting on May 1 noted that "various participants mentioned a willingness to tighten policy further should risks to inflation materialize in a way that such an action became appropriate."

While the Fed appears affixed to the sidelines for the foreseeable future, the Bank of England (BOE) and the European Central Bank (ECB) are seemingly preparing for a near(er)-term rate reduction. Following in the footsteps of Switzerland, Hungary, Sweden, and the Czech Republic, which all initiated policy easing over the past two months, the ECB, citing weak economic activity amid declining inflation, is poised to lower its key policy rate as early as next week. And, the BOE is likely not far behind. Of course, with the outlook for inflation improved but still uncertain globally, even those central banks willing to adjust rates sooner than later have warned, going forward, policy should be characterized by caution.

EUROPEAN CENTRAL BANK: RATE CUT IMMINENT

Amid sluggish growth and encouraging signs of disinflation, the European Central Bank is widely expected to cut rates in June. In fact, at 98%, a first-round 25 basis point rate reduction in the deposit rate from 4.00% to 3.75% in just six days' time appears all but certain.

Of course, even with heightened expectations of an inaugural rate reduction next week, a recent pickup in labor costs suggests the ECB will likely take a tempered approach to subsequent reductions and the future pathway of policy. Down from an earlier

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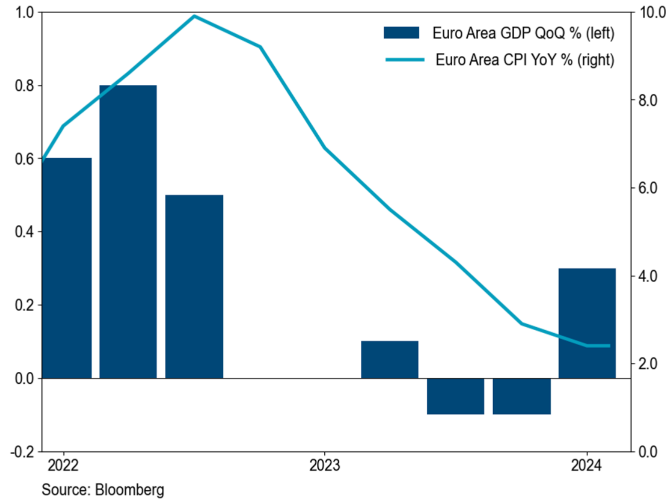
forecast of six rate cuts at the start of the year, market participants now anticipate one or two reductions in the remaining six months of the year on a quarterly basis at best. According to members of the governing council, given the still *"bumpy"* nature of the data, *"Policy rates will slowly but gradually move to less restrictive levels."* The exact timing, speed or scale of policy adjustments will follow *"a data-dependent approach."*

The European economy has been sluggish for some time, with two consecutive quarters of negative growth at the end of last year. More recently, however, activity levels have improved, rising 0.3% in Q1 with expectations for an average 0.7% pace throughout the year.[1]



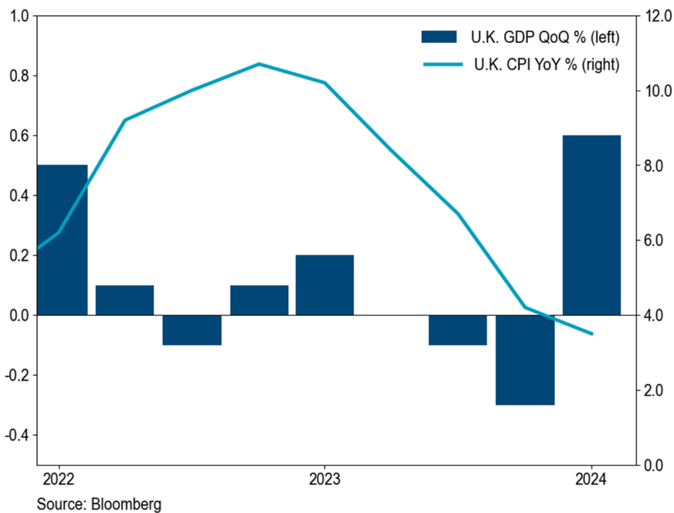
Source: Bloomberg

Meanwhile, inflation has slowed markedly in the Eurozone from a peak of 10.6% in October 2022 to 2.4% as of April. However, with wage growth steady at 4.5% as of Q4 2023, any unexpected increase would not necessarily derail the committee's intentions to move in June, but certainly extend the time between the first and second policy adjustments.

BANK OF ENGLAND: POLICY ADJUSTMENT NEAR(ISH)-TERM

Despite earlier expectations for a mid-year rate reduction alongside the ECB, stronger-than-expected wage data in the U.K., as well as an untimely election have extended the anticipated timeline for rate relief by the Bank of England.

The latest inflation figures showed the Consumer Price Index falling sharply from 3.2% to 2.3% in April, the slowest pace since July 2021. The improvement, however, fell short of expectations for a larger reduction to 2.1%. Coupled with a larger-than-expected rise in February wage data, concerns of upside risks to price pressures continue, particularly in services costs, which remain a key focus of British policy makers.



Source: Bloomberg

Along with inflationary uncertainty, the U.K. economy has broadly shown significant signs of acceleration. Exiting last year's recession (Q3-Q4) with an annual growth rate of just 0.1%, the U.K. economy grew by 0.6% in the first three months of 2024, exceeding expectations and marking a three-year high.

[1] Link to report: https://www.reuters.com/markets/rates-bonds/june-ecb-rate-cut-done-deal-majority-expects-cuts-sept-dec-too-2024-05-29/

GLOSSARY

BOE – Bank of England

CPI – Consumer Price Index

ECB – European Central Bank

FOMC – Federal Open Market Committee

GDP – Gross Domestic Product

MPC – Monetary Policy Committee

QoQ – Quarter over Quarter

YoY – Year over Year

While a June rate cut is not off the table entirely, barring a clear and present need for the BOE to step in and provide relief to stabilize economic conditions, the Monetary Policy Committee (MPC) seemingly would be less inclined to adjust rates or add unnecessary volatility in the coming weeks, particularly in the face of the July 4 general election. As such, market participants continue to anticipate only one BOE rate reduction in 2024, in November at the earliest.

FEDERAL RESERVE BANK OF THE UNITED STATES: ON HOLD … INDEFINITELY

While the ECB and BOE are both rapidly approaching a pivot point in policy, the Fed continues to reiterate a message of *"patience."* Market expectations for rate cuts have dropped from as many as six or seven at the start of 2024 to just about two more recently. Like its counterparts abroad, the Fed continues to maintain a policy bias towards easing – *eventually* – as this is clearly a Committee desperate to provide relief and continue to perpetuate positive economic conditions. The Fed was arguably tardy to the inflation-taming party in 2022, and now, amid positive growth, elevated price pressures, and upside inflationary risks, it will likely delay participating in the policy-easing festivities.

The domestic economy has lost momentum from an outsized annual growth pace of 2.5% in 2023 to just 1.3% at the start of this year, but growth remains solid, as the U.S. economy has avoided a technical recession that plagued much of the developed world. Furthermore, with inflation in the U.S. stabilizing well above 2%, and surprising to the upside January through March, Committee members have been crystal clear that it will take *"many"* more months of improving data before a disinflationary trend can be reestablished to justify a reduction in policy rates.

Additionally, like the BOE, the Fed – while autonomous from the federal government – would likely seek to avoid a meaningful policy adjustment as the November election approaches. The Fed has in the past increased and lowered rates during an election year both with an incumbent Democrat and an incumbent Republican in office; however, without a clear reason or need to amend policy, the Committee may be more inclined to avoid taking center stage as Americans head to the polls.

DIVERGENCE OF CENTRAL BANK POLICY

The growing divergence in global central bank policies is not unusual and in many ways, it simply reflects the diverse economic environments from country to country. Looking at the Fed, ECB, and BOE over the past five rate cycles,[2] there isn't a clear policy leader when it comes to being the first to make a rate hike or cut. However, regardless of the first to make a move, the remaining two global players typically respond in kind six months later on average, depending on the evolution and dispersion of domestic and political conditions.

In February 2005, for example, with GDP at 4.5% and inflation climbing to 3%, the Fed opted to hike rates for the first time, nearly a year before the ECB adjusted policy higher with growth still sluggish under 1% and inflation near the Committee's target at 2.2%. However, in December 2021, the BOE was the first to raise rates, with the Fed following suit just three months later in March 2022. U.K. inflation at the time of the increase was 5.4% and GDP was 1.5%, whereas U.S. inflation at the time of the first-round rate hike was 8.5% with growth still grossly negative, off 2%.

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[1] The ECB came into formal existence on June 1, 1998, and took over responsibility for the monetary policy of the EMU member states on January 1, 1999.

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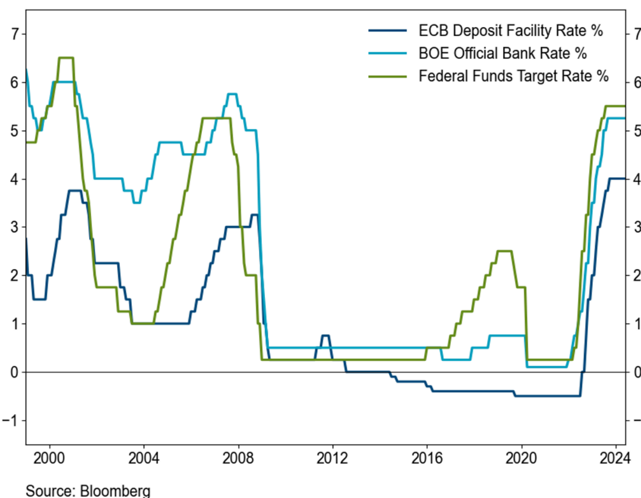
Similarly, in September 2007, while the Fed was the first to ease policy, eventually lowering rates to a floor of 0.25% in December 2008, the BOE followed closely behind, initiating rate cuts three months later and ultimately lowering to 0.5% over 16 months. The ECB, meanwhile, with growth at 0.4% and inflation at 2.1% in Q3 2007, instead initiated another round hike to 3.25% in July 2008 before lowering rates nearly a year after the Fed first initiated policy easing, eventually cutting rates to 2.75% in November of 2008.



Source: Bloomberg

Global monetary policy makers have varying mandates, and they focus on different measures of economic conditions. However, they are all largely data driven. Thus, with the ECB citing declining survey-based inflation expectations and a relative reprieve in wage pressures, European policy makers feel justified possibly moving towards easing policy as early as the June 6 meeting. Alternatively, the Fed has indicated a sidelined position for potentially *"many"* more months, as it faces a still *"spendy"* consumer, a bloated government balance sheet, as well as longer-term supply-side constraints, weakening demographic trends, and geopolitical risks. Of course, with upside risks to inflation, the Committee may at some point also need to consider not just a delay in rate cuts, but actively engaging in additional rate *hikes*.

A policy pivot by the Fed's global counterparts will not in and of itself dictate an immediate similar action from the Fed. The Committee appears to be steadfast in achieving its dual mandate of stable prices and full employment, regardless of overseas actions. Nevertheless, the growing divergence in central bank policy will play a critical role in the health of the U.S. economy and strength of the dollar, as well as potentially dampen demand for U.S. Treasury securities. All of that will complicate the Fed's goal of reinstating stable prices amid a soft landing.

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