Sensitive Expectations

It is a tricky balancing act for central banks in trying to engineer a slowdown in economic activity to lower inflation, by tightening monetary policy, without going too far in hiking rates, and having an even greater contractionary impact on demand. The IMF, as well as the OECD, amongst others, continue to warn about this risk, with the possibility that 'sticky' core inflation and tight labour markets could necessitate even higher rates.

During their current tightening cycles, the US Fed has hiked rates by 475bps so far, the Bank of England has raised rates by 415bps, while the ECB has executed 350bps worth of rate hikes. This has seen official rates rise to 4.875%, 4.25% and 3.00% in the US, UK and Eurozone, respectively.

More recently, central banker's policy deliberations have been further complicated by the stresses that emerged in parts of the global banking system in March and the substantial market volatility that followed. The aforementioned sharp rises in interest rates exposed financial vulnerabilities in some banks.

Stress in the banking sector could see a further tightening of credit conditions, which may in turn have a significant dampening effect on the real economy, especially in the US. The initial reaction to concerns about the banking sector saw markets anticipate fewer rate increases and earlier rate cuts, as a result of likely tighter credit conditions.

However, the recent easing of concerns in relation to the global banking sector, combined with some upside surprises to economic data has seen some renewed firming in market rate expectations over the last fortnight. Indeed, with central banks now espousing a data dependent, meeting-by-meeting approach to their policy decisions, markets have become much more reactive to key data releases and central banker's comments.

We have seen examples of this recently. The higher than expected UK inflation for March, released last week, saw an immediate hardening of BoE rate expectations, with futures contracts now reflecting a view that the Bank rate could peak between 4.75-5.00%. The previous week, hawkish ECB comments saw Eurozone futures contracts envisage rates rising by 75bps (rather than 50bps), from their current levels.

Meanwhile, US futures contracts are now pricing in another 25bps increase from the Fed, whereas previously the market had started to assume the Fed funds rate had peaked. The market though continues to expect the Fed to start cutting rates in the second half of the year, although, the extent of rate cuts penciled in for this year is now 50bps compared to 75bps at the end of March. Both the ECB and BoE are not anticipated to cut rates until the first half of 2024.

Overall, the outlook for official rates has a fair degree of uncertainty attached to it, with the trajectory of 'core inflation' being a key determinant, as well as evolving credit conditions in the banking sector.

What is certain, is that market rate expectations will remain sensitive to important data releases, especially in relation to inflation, central bank speaker's comments, as well as, any further issues in the global banking system.

John Fahey,
Senior Economist,
AIB

AIB Customer Treasury Services
DUBLIN / CORK
aib.ie/fxcentre

Customer Treasury Services NI
BELFAST
aibni.co.uk/fxcentre

Customer Treasury Services GB
LONDON
aibgb.co.uk/fxcentre

This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by First Trust Bank. In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and First Trust Bank are trademarks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street, Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.