No Christmas Harmony

The US economy has been the star performer this year, with GDP set to expand by 2.5% and the unemployment rate stable at below 4%. This stands in marked contrast to the Eurozone and UK economies, which have largely stagnated in 2023. However, despite the weakness of European activity, the ECB and Bank of England stuck to the script at their policy meetings last week, indicating that they will need to keep policy tight well into next year in order to bring inflation back down to its 2% target, with no room for early rate cuts.

ECB President Lagarde was very direct, saying "we did not discuss rate cuts at all" and we "should absolutely not lower our guard". Meanwhile, the BoE indicated that policy would need to remain restrictive for an extended period of time, backing up comments earlier this month from its Governor that "we are not in a place now where we can discuss cutting rates – that is not happening". This strong line from Europe's two main central banks was augmented by the decision of the Norwegian Central Bank to actually hike rates further last week.

By contrast, the US Federal Reserve gave strong signals that rate cuts are coming on to the agenda. Fed Chair Powell indicated that the question of rate cuts is "coming into view" and there was a general expectation amongst Fed policymakers that it "will be a topic of discussion of conversation going forward". He added that the Fed sees real progress being made on lowering inflation so the question becomes when will it become appropriate to begin dialling back on its policy tightening.

This is a remarkable divergence in the messaging of central banks. The markets ignored the commentary from the ECB and BoE and instead priced in an even more aggressive pace of policy easing in all markets for next year on the back of the remarks from the US Fed. Rates are now seen as being cut by around 150bps in the Eurozone and US in 2024 and 120bps in the UK.

In fairness, the ECB and BoE are not saying that rates won't be cut next year. However, they are clearly uncomfortable about the extent of policy easing that markets are pricing in for 2024 and expectations that rates will begin to be cut in the coming months. Both central banks will need to see more progress made on lowering inflation and a marked easing in wage pressures, before loosening policy.

Unit labour costs rose by 6.6% year-on-year in the third quarter of this year in the Eurozone, while in the UK, average earnings are growing at over 7% year-on-year. Such high rates are not consistent with inflation falling back to its 2% target on a sustained basis. Thus, we can expect to see the ECB and BoE pay very close attention to wage settlements this coming spring.

Indeed, even in the US, we think it will be early summer before the Fed starts to lower interest rates. Core US inflation is still running well above target, with the core CPI rate at 4% and the broader core personal consumption expenditure deflator running at 3.5%. While there was a big divergence in communications from the main central banks last week, they may be more in sync when it comes to policy easing in 2024.

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