



More Rate Hikes to Come

Markets could be in for more pain in 2023 after central banks re-asserted their inflation fighting credentials last week. In particular, both the US Fed and ECB signalled that markets have not built in enough rate tightening for next year and are too optimistic on the timing of a shift to policy loosening.

Both central banks revised up their inflation forecasts for 2023, which is expected to prove more persistent than previously anticipated. Their clear message was that rates will need to rise by more than markets expect and policy will have to remain restrictive for a prolonged period of time to return inflation back to its 2% target.

The most striking thing about the Fed is the strong bias amongst policy makers to take rates above 5%; ten of the nineteen members of its monetary policy committee see rates getting to 5.125%, while seven more see rates peaking above this level. This is very much at variance with the market's view that rates will top out at 4.875%.

Moreover, the market's expectation that rates will be cut by 50bps to 4.375% by end 2023, is completely at odds with the Fed projection that they will end next year above 5%. Further out, the market's view is that rates will end 2024 at 3.125%, which is 100bps below the 4.125% level projected by the Fed.

Meanwhile, the very hawkish rhetoric from the ECB caught the markets by surprise. While there was the anticipated downshift to a 50bps hike, this was accompanied by a clear message that the ECB will have to maintain rate increases at this pace for some time. It indicated that rates will have to rise significantly more at a steady pace to reach levels that are sufficiently restrictive, and then be held there to ensure a timely return of inflation to its 2% target.

The key deposit rate has now been increased to 2% and the ECB's clear guidance suggests it could rise to 3.5% or above next year. Futures contracts hardened by about 40bps in the aftermath of the ECB meeting and they are now pricing in a peak of around 3.25% in rates next year. Markets still anticipate that rates will be cut by 50bps in 2024.

Central banks are clear that they will stay the course and do what is required to get inflation back down to target. Markets, though, seem doubtful that they will tighten rates to the extent they are guiding and then maintain such a restrictive policy stance for a prolonged period of time. The markets may well be taking a more benign view of inflation in 2023-24. Recent declines in headline CPI rates, marked falls in commodity prices over the second half of this year and the likelihood of very weak growth or recession in 2023 may be encouraging markets to believe that inflation will fall more quickly than anticipated by central banks.



Nonetheless, interest rates seem likely to rise by more than markets expect in the first half of 2023 given the strong bias of central banks to continue on an aggressive tightening path. Markets, though, may well be correct that policy can begin to be eased at a quicker pace thereafter than central banks are guiding.

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