No Let Up in Rate Hikes

The shift by central banks to smaller rate hikes is not a signal that monetary tightening is about an end. Central banks have continued to emphasise that the battle to bring inflation back under control and restore price stability is far from won. They have been guiding that further hikes are on the cards and rates will need to go higher than previously anticipated. They have also moved to quell expectations of rate cuts before year-end, indicating that policy will need to be kept tight for a prolonged period of time to return inflation to target.

The US Federal Reserve opted for a 25bps rate hike at its last policy meeting in early February, bringing the target range for the funds rate up to 4.5-4.75%. The Fed's interest rate projections from December revealed near unanimity on its monetary policy committee that rates will need to rise above 5% in 2023. Since then, US data have printed on the strong side, leading markets to start pricing in that rates will be hiked to a 5.25-5.5% range by mid-year.

Further out, markets have greatly scaled back their expectations on rate cuts. They now see rates ending the year at 5.25% compared to 4.5% in mid-January. Futures contracts then see rates being cut to around 4% by end 2024, up from 3% a month ago, with rates now expected to be pitched at above 3.5% by end 2025, up from 2.75% previously.

Meanwhile, the Bank of England hiked rates by 50bps in early February, bringing the Bank Rate up to 4%. There were expectations at the time that it would do one more 25bps hike and then put policy on hold. The Bank, though, retains a tightening bias, noting that further rate increases would be required if there is evidence of persistent inflationary pressures.

UK data have been coming in ahead of expectation recently, while wage inflation remains high amid tightness in the labour market. Thus, futures contracts are currently envisaging a peak in rates at 4.75% this summer. Only modest rate cuts of circa 75bps are envisaged in 2024-25.

The ECB has given a clear signal that rates will be hiked by 50bps at its March meeting, bringing them up to 3%. Market expectations for the peak in rates have firmed considerably in the past month. Further contracts now see rates rising to at least 3.75% this summer, up from 3.25% in January. Rate cuts are no longer seen on the cards for later this year, with markets looking for a modest 75bps of easing during 2024-25.

Markets then have lifted their expectations of the peak or terminal rate across markets in the past month. However, of greater significance is that they now expect rates to remain elevated over the medium term. The risk to this view is if the time lag in terms of monetary policy impacting economic activity is being underestimated by central banks and markets.

This could see both growth and inflation turn out to be much weaker than anticipated in the coming year, which would set up the prospect of significant rate cuts in 2024-2025. For now, though, stronger than expected data will encourage central banks to keep the pedal to the floor and continue hiking.

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