



Markets May Be Overly Optimistic on Rate Cuts

Further significant declines in headline and core inflation rates look to be in store this spring virtually everywhere, as large price increases a year earlier drop out of the annual comparison. Monthly increases in core inflation last spring, averaged 0.8% in the Eurozone and 1% in the UK, with the core US PCE deflator rising by an average of almost 0.4%. These monthly rises have moderated greatly since then.

Meanwhile, economic activity remains very weak in Europe and appears to be starting to slow in the US. Taking all the above together, markets are pricing in 130-170bps of rate cuts in the main economies this year, most likely beginning with the Fed meeting on the 20th of March, the ECB on April 11th, and BoE on May 9th. There is a risk, though, that rates may not be cut as quickly as markets expect.

First, headline inflation has been quite volatile in recent months, and central banks will want to see a clear downtrend re-emerge before loosening policy. Second, labour markets remain tight, with resulting strong growth in wage earnings and unit labour, as referenced by the BoE and ECB. Third, core inflation is also still quite some way above target, most notably in the UK. Central banks will want to be sure that inflation is on a clear path to 2% on a sustained basis before embarking on rate cuts.

Indeed, central banks have been sounding words of caution in relation to market expectations for extensive rate cuts in 2024. In December, the ECB noted its forecast for a return of inflation to its 2% target was based on a much higher trajectory for interest rates than priced in by markets. Its macro projections are based on three month rates averaging 3.6% this year and troughing at around 2.75% next year, well above current market pricing.

Meanwhile, the BoE Governor stated that the MPC is not in a position to even discuss cutting rates. Indeed, it still retains a tightening bias. Most noteworthy, the median projection of Fed Board members in December was that rates would be cut by just 75bps this year, less than half of current market expectations for easing of around 170bps.

The central banks, though, do acknowledge that they have moved to a 'data dependent' mode in terms of monetary policy decisions. Thus, policy easing could prove to be greater than they currently envisage if warranted by incoming data. Hence, the importance of inflation figures this coming spring, as they will need to show that price stability is coming onto the horizon. Headline inflation could fall to circa 2% or below, with core rates coming within sight of this level. It will be difficult for central banks not to begin easing policy if this is what the inflation data show.



Even then, central banks will need to be convinced that it is a sustained fall in inflation. Indeed, the possibility of near-term inflationary shocks, such as the current Red Sea shipping disruption, could temper rate-cutting plans for central banks. Thus, it is hard to envision rates being cut before June, with the possible exception of the US where the Fed has acknowledged that rates are now at a relatively high level in real terms and that cuts are coming into view. It may also be the case that central banks don’t cut rates at every policy meeting once easing gets underway, as is currently anticipated by markets for 2024.

David McNamara
Chief Economist
AIB

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