CENTRAL BANK PIVOT DELAYED, BUT STILL COMING

CENTRAL BANKS TO FRONT-LOAD MORE RATE HIKES UNTIL SOMETHING BREAKS

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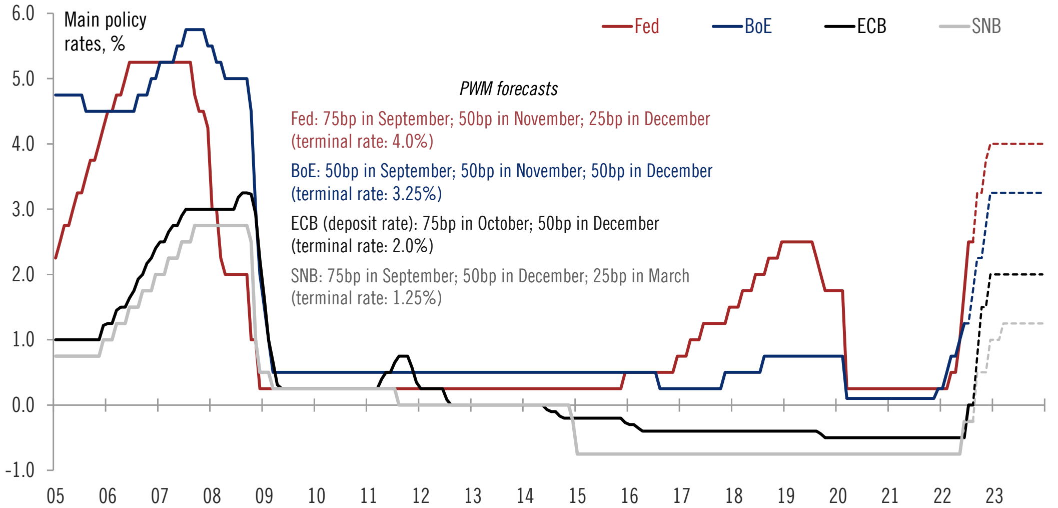
SUMMARY

- We ‘mark-to-market’ our policy rates forecasts taking into account a more resilient labour market in the US, and the central banks’ hawkish reaction function.
- US consumer inflation eased only modestly to 8.3% in August amid persistent core price pressures, leaving the Federal Reserve (Fed) on high alert for now. A third 75bp ‘jumbo’ rate hike is likely on 21 September, followed by 50bp in November and 25bp in December, pushing the Fed’s terminal rate to 4.0% (versus our previous expectation of 3.25%). As growth and employment start to deteriorate by the turn of the year, we think the Fed will cease hiking in 2023, but not lower rates again.
- A delayed Fed pivot may create room for other central banks to tighten their policy stance for longer – especially in Europe where inflation has not peaked yet.
- We expect the European Central Bank (ECB) to front-load more rate hikes, bringing the deposit rate to 2.0% by year-end (previously: 1.50%) and the Swiss National Bank (SNB) to catch up faster to 1.25% (previously: 0.75%).

More monetary frontloading, higher terminal rates, and no cuts in 2023

Central banks have made it abundantly clear that they intend to reduce inflation, even at the expense of growth. Given their bad track record on inflation so far this year, and given the risks of second-round effects from the energy shock (especially in Europe), we expect **central banks will ”keep at it” until their job is done**—in other words until they see convincing evidence of slowing demand and inflation. Their approach might be backward-looking, putting more weight on current inflation data than on expectations and forward-looking indicators, but this is the reality of their new reaction function.

CHART 1: CENTRAL BANKS’ POLICY RATES INCLUDING PROJECTIONS



Source: Pictet Wealth Management, Bloomberg Finance L.P., 13.09.2022

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US: a resilient job market may cause the Fed to keep hiking

Despite numerous internal and external challenges, including the winding-down of pandemic support packages and the normalisation of demand growth, the **US labour market is still humming**. Payroll growth averaged a robust 378,000 per month in the three months to end-August. New jobless claims, while they have risen from their March 2022 lows, are still very modest; the 'jobless claims unemployment rate' is only 1.0%. Focusing on labour market trends, **the Fed may conclude that the US economy can easily absorb additional monetary tightening**.

While CPI inflation has started to ease, the August CPI report was disappointing. Headline inflation slowed only modestly from 8.5% to 8.3 year-on-year (y-o-y) in August while core CPI was much stronger than expected at 0.6% on the month and 6.3% y-o-y. Details were consistent with **a frustratingly slow deceleration in core price pressures**. Looking at the 'sticky' services items, medical services inflation rose to 5.6% YoY while shelter and rents rose to 6.2% and 6.7%, respectively. Still, we don't think these numbers mark a reversal in trend. We forecast CPI inflation to decline to close to 6% in Q4 2022.

Meanwhile, recent Fed commentary has been surprisingly hawkish. Chairman Jerome Powell in his brief Jackson Hole speech said that combating high inflation remains the Fed's overarching priority. Echoing these hawkish comments at a conference on 8 September, Powell did not push back against market pricing of future rate hikes.

The Fed seems especially worried about two things: first, while they have been easing, that inflation expectations become de-anchored if high inflation persists; second, that a tight job market continues to boost wage growth, with the risk of a wage-price spiral (although recent data show some moderation in wage growth).

In short, the Fed's 'reaction function' seems to be still very much based on **actual inflation** rather than the **trajectory of future inflation**. The one-year US inflation swap is pricing 'only' 2.5% inflation over the next twelve months.

As a result, we have adjusted our Fed scenario to take into account the new reaction function, and the stronger-than-expected momentum in the US job market. **We now believe the Fed will hike by 75bps on 21 September, then 50bps on 2 November. We expect a final hike of 25bps on 14 December, bringing the terminal rate for the top fed funds target rate to 4.0%**. Following the August CPI print, fed funds futures have moved to price in a peak of 4.30% by March 2023.

Our expectation of a slowdown in the pace of monetary tightening, and ultimately a pause, would be based on the following metrics:

- **Non-farm payrolls slowing to a moving average of 150,000** per month, or lower;
- Business indicators like the **ISM purchasing manager indexes showing outright contraction** in economic activity or an impending recession (the ISM manufacturing index was a still resilient 52.8 in August, indicating a mild expansion in activity); or

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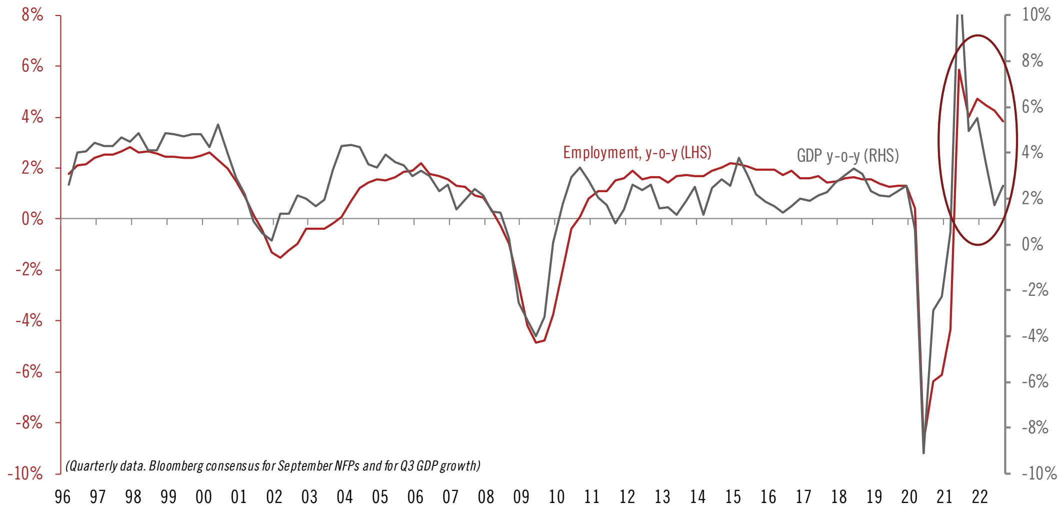
- **Core PCE inflation** (the Fed's preferred gauge) falling below 0.2% month-on-month over several months (it has averaged 0.35% in the past three months).

CHART 2: THERE IS AN ESPECIALLY PRONOUNCED DIVERGENCE BETWEEN GDP AND THE LABOUR MARKET



Source: Pictet Wealth Management, Bloomberg Finance L.P., 13 September 2022

Europe: hiking to neutral in a timely fashion

A delayed Fed pivot may allow central banks in Europe to continue tightening their policy stance for longer as inflation has not peaked yet in either the euro area or the UK.

We now expect the **ECB** to frontload more tightening in coming months. Having already raised the deposit rate by 75bp last week, we expect it to raise rates by 75bp again in October and by 50bp in December, bringing **the terminal rate up to 2.0% at year-end** (versus our previous forecast of 1.50%).

By reducing downside risks to growth, a further decline in gas and electricity prices may lead to a more aggressive ECB. However, the scenario we deem as most likely is for Russia to cut gas flows to Europe entirely (with some small exceptions such as Hungary). Indeed, by making the resumption of Nord Stream 1 gas supplies conditional on the lifting of sanctions, Russia has officially signalled its willingness to 'weaponise' energy supplies. With winter approaching, Vladimir Putin knows that his leverage increases as temperatures drop. Rapidly rising gas storage levels in Europe only incentivise him to act more quickly, especially as Russia's revenues from gas exports only represent a third of what it earns from oil sales. The latest geopolitical developments also raise the risk of further tensions in European energy supplies. Ukraine's counteroffensives, which has been unexpectedly successful so far, at least in eastern Ukraine, may prompt a harsh response from Russia, both militarily and through further squeezing energy supplies to the West. Attempts by G7 countries to cap oil and gas prices may prove the last straw, pushing Putin to act on his threat to stop selling energy to countries that set price caps.

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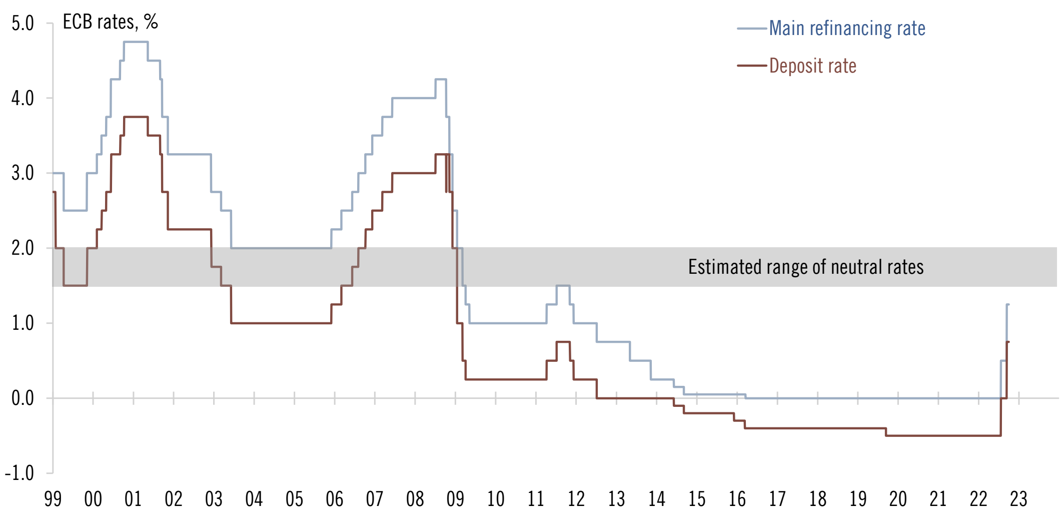
The European growth outlook remains highly dependent on energy prices and government interventions. While fiscal support measures for households and companies may mitigate the drop in real income and overall economic activity, they will not fully offset the impact of renewed energy hardship (see "Euro area: a policy-mix dictated by energy worries", 29 august 2022). Taking everything into consideration, **our forecast of zero real GDP growth in the euro area in 2023 remains below consensus forecasts and below the ECB staff projections** of 0.9%.

We expect the ECB to downgrade its own outlook to include a recession at the turn of the year, a move that should provide it with a justification to pause tightening. However, **the ECB could tighten its stance (or at least not ease it) via other policy instruments**. In particular, we expect Quantitative Tightening to start in 2023 via the ending of reinvestments of debt securities under the Asset Purchase Programme (APP). The ECB's balance sheet will also shrink as Targeted Longer-Term Refinancing Operations (TLTRO) mature, including EUR1.2 trn in June 2023 alone.

In the near term, whether the ECB hikes rates by 50bp or 75bp at its 27 October meeting is a close call. But the likelihood that headline and core inflation edge higher in September may tip the balance. The ECB will also have the next release of the Survey of Professional Forecasters to consider before its Governing Council's October meeting. But even if inflation expectations were to ease, other consumer surveys are still too elevated and wage growth is likely to pick up in coming quarters, keeping the ECB on high alert.

CHART 3: ECB POLICY RATES AND THE ESTIMATED RANGE OF NEUTRAL RATES



Source: Pictet Wealth Management, Bloomberg Finance L.P., as of 9 September 2022

In Switzerland, we forecast the **SNB** to deliver larger rate hikes as well; 75bp in September and 50bp in December, followed by a final 25bp rise to reach **a terminal rate of 1.25% in March 2023**. With consumer price inflation above the SNB's upper tolerance-band of 2%, the SNB will likely continue to favour a strong CHF as a first line of defense against such imported price pressures, including by keeping a broadly stable rates differential with the ECB.

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