WHAT'S HOT: CENTRAL BANKS NAVIGATE THE LAST STRETCH IN THEIR TIGHTENING CYCLE

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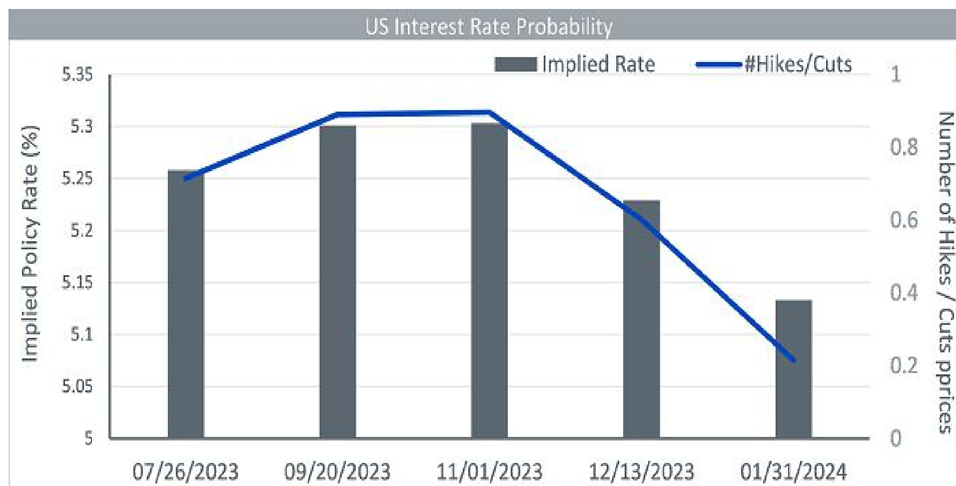
This week we learnt how vital Central Bank communication is to global financial markets. The trio of central banks – The Federal Reserve (Fed), European Central Bank (ECB) and the Bank of Japan (BOJ) held their respective meetings. Each of the central banks tried to convey how they will navigate monetary policy amidst a slowing economy and avoid a hard landing.

China takes small steps to shore up the recovery

Even the People's Bank of China (PBOC) surprised the markets this week, by announcing a cut in the 7-day Open Market Operations (OMO) by 10Bps to 1.9%[1] which paved the way for another cut to the one-year medium term lending facility rate by 10Bps to 2.65%[2]. These recent developments mark a more proactive stance by Chinese policy makers in trying to tackle the Chinese slowdown in activity since the re-opening. Clearly more is needed. Policymakers are soliciting opinions from business leaders and economists on how to revitalise the economy in a number of urgent meetings[3]. While the Fed and ECB are trying to tame inflation, China has the opposite problem as inflation remains low. Manufacturing remains weak, exports are slowing, and credit growth is cooling. This is why it's no surprise that the markets are prepping for a broader package of stimulus targeted towards the ailing property sector.

A hawkish skip for the Fed

The recent flurry of economic reports continues to show the US economy is holding up but losing steam, supporting the Fed's approach of changing the pace of its policy tightening. The Fed kept the fed funds rate in range of 5-5.25%, by unanimous vote, in line with market expectations after 10 straight hikes dating back to March 2022.



Source: Bloomberg, WisdomTree as of 16 June 2023.

Historical performance is not an indication of future performance and any investments may go down in value.

The Fed's dot plot showed the median rate at 5.6% versus 5.1% a month back. In the summary of economic projections, the median unemployment rate forecast was revised lower from 4.5% to 4.1% by the end of 2023 while the core inflation rate was revised higher from 3.6% to 3.9% making the case for more hikes this year. This clearly was a hawkish skip.

Fed Chairman Jerome Powell was careful to point out that no decision was made on a July hike, but he did say it is a live meeting, leading the market to increase the probability of a move. What surprised me the most, was that Powell said rate cuts would be a couple of years out which is at odds with the dot plot forecast of 100Bps of cuts in 2024.

Senior Economist to WisdomTree Jeremy Siegel believes the Fed is done hiking and that alternative inflation metrics which incorporate real time housing inputs show inflation running at 1.4% instead of 4.1%. This is based on alternative shelter inflation calculations using Case Shiller Housing and Zillow rent annualized at 0.5% instead of the 8% that is biasing Bureau of Labor Statistics (BLS) CPI higher.

ECB's revised inflation forecasts remain at odds

After raising the deposit rate by 25Bps to 3.5%, the ECB was a lot clearer than the Fed in signalling that rate hikes are almost certain next month on July 27. The ECB remains too optimistic on growth, reducing their projection for 2023 real GDP to only 0.9% (from 1% in its March projections).

Figure 1: Forecasts for inflation and GDP growth (in % YoY)

	Inflation			Core Inflation			Real GDP		
	2023	2024	2025	2023	2024	2025	2023	2024	2025
ECB June Projections	5.4	3	2.2	5.1	3	2.3	0.9	1.5	1.6
ECB March Projections	5.3	2.9	2.1	4.6	2.5	2.2	1	1.6	1.6
Bloomberg Consensus	5.5	2.5	2.1	5.1	2.7	2.1	0.6	1	1.6

Source: ECB, Bloomberg, WisdomTree as of 15 June 2023.

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While I would agree with the ECB's view that (1) mostly labour-intensive services will support economic growth over the next two years and (2) the current hump in wage inflation will show up via higher prices for these services, I remain sceptical amidst the global headwinds for manufacturing, and a slower pace of overall growth could keep inflation as high as the ECB now projects. While wages are likely to accelerate slightly above 5% in 2023, they should begin declining to 4% yoy by late 2024. We believe, if core inflation continues to recede in the coming months and the real economy grows at 0.4% in 2023, the ECB will stay put in September after a final move next month.

As expected, the ECB confirmed that it will stop to reinvest proceeds from maturing bonds under its standard Asset Purchase Programme (APP) from July onwards. It won't offer new long term liquidity injections upon the expiry of the €477Bn of a TLTRO III liquidity measure on 28 June 2023.

BOJ sits tight

As expected, the BOJ kept all key policy settings unchanged, including the +/-50Bps band around the zero% Japanese Government Bond JGB yield target. Since taking the helm in April 2023, BOJ Governor Kazuo Ueda has stressed the high cost of premature tightening as the economy is finally seeing green shoots toward sustainable inflation.

In contrast to the ECB, the BoJ's latest assessment and outlook for the economy and inflation were also largely unchanged from their update in the April Outlook Report. The BoJ continues to note "extremely high uncertainties" surrounding economies and financial markets at home and abroad." Japanese equity markets reacted positively to the BOJ's status quo stance on monetary policy. Looking ahead, the Fed's potential pivot back to a hawkish mode versus the BOJ's dovish perseverance could pave the way for further upside for Japanese equities owing to the underlying weakness in the Yen versus the US dollar.

Sources

[1] Bloomberg on June 13, 2023

[2] Bloomberg on June 15, 2023

[3] Bloomberg on June 14, 2023

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