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MACRO MORNING BRIEFING

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Revisiting Rate Optionality

Multiple narratives are in play as central banks reconvene

- Inflation is proving stickier than anticipated, but rate cuts should not be ruled out
- High real income buffers do not imply solid demand growth
- FX carry interest not on solid foundations

G5 rate expectations need to de-synchronise

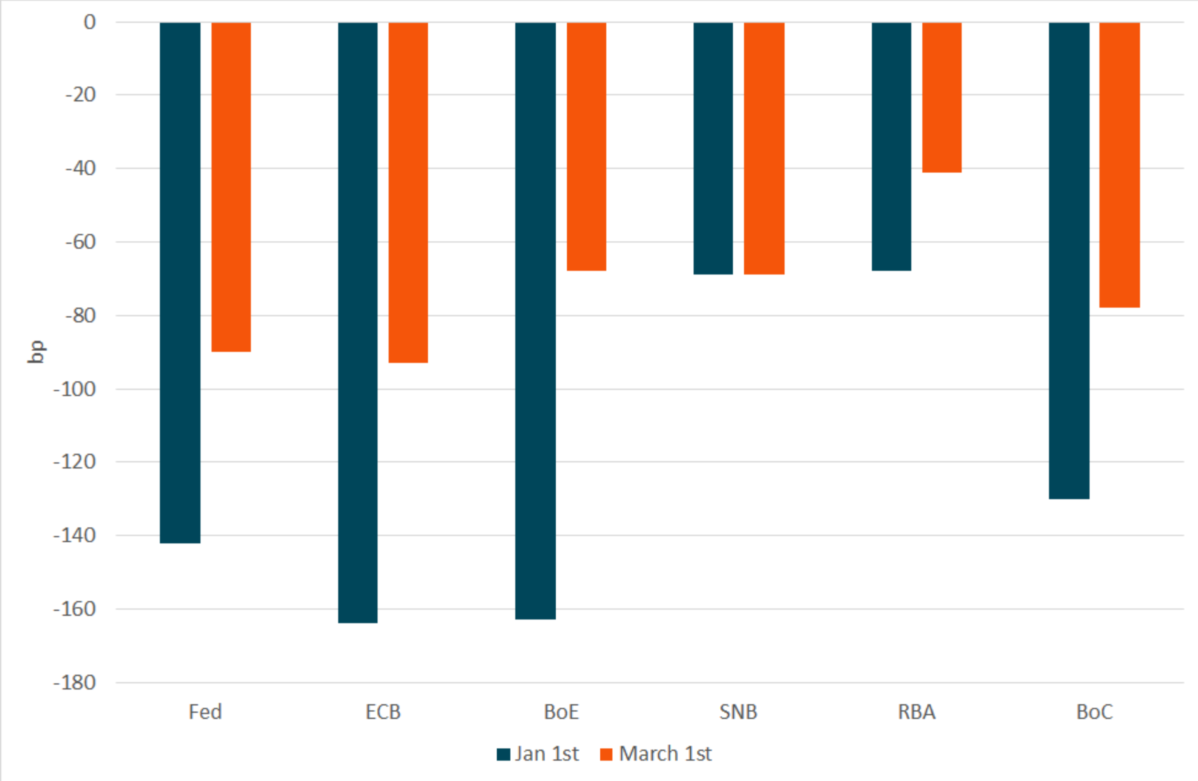
The March policy cycle kicks off this week with decisions from the Bank of Canada and European Central Bank on Wednesday and Thursday, respectively. Neither is expected to alter policy rates, but this will be the first opportunity for markets to assess the general narrative around a rebound in inflation risk. Policymakers have already underlined stubborn wage growth as a barrier to rate cuts, especially the risk that gains in real wage growth could lead to a new round of demand expansion. Even though the US's most recent PCE figures were in line with expectations, such risks are nonetheless pertinent for the Federal Reserve, too. Asset allocation at present is predicated on US economic and growth exceptionalism, which could justify some adjustment in rate pricing for the Fed. The US economy may take precedence in generating global demand, especially with growth in China still struggling for traction, but we caution against simply extrapolating that there is sufficient expansion capacity in the US to reflate the global economy and shift policy paths.

Outside of the Fed, policymakers have not been attributing current inflation vigilance to US developments. There have been comments regarding the potential for a new round of technology-based productivity gains which could support real wages while limiting headline inflation. But even the realisation of such scenarios would fall well beyond the current policy horizon. For now, outside of the US, domestic wage persistence remains the key concern, and there has been very limited policy guidance regarding the potential for re-acceleration in earnings. If anything, it is pass-through risk that could present a problem. However, and setting aside USDJPY, with the US dollar having failed to make much headway against key counterparts, and with energy and commodity prices subdued, imported inflation through the price or income streams seems unlikely, as well.

All of this makes the recent pullback in easing expectations more surprising. Exhibit 1 below shows a material pullback in rate expectations in key markets since the beginning of the year. Only pricing for the Swiss National Bank has remained static, though it remains to be seen whether the surprise resignation of President Jordan (he will depart at the end of September) will change policy execution. Furthermore, also evident is that Fed pricing has moved the least. ECB pricing now has three fewer cuts, and Bank of England pricing four fewer. Without context, these changes suggest that Europe is outperforming the US, rather than the other way around. While it is reasonable to assert that some pricing of easing toward end-2023 in Europe was too extreme, the pullback now also seems excessive.

Policymakers stressed at the beginning of the year that extreme pricing of cuts risked loosening financial conditions too much, such that inflation could rebound. So far, credit and activity indicators do not point to re-acceleration in activity, so guidance on this matter can be deemed a success. Nonetheless, considering that survey data continues to point to demand weakness and global manufacturing contraction, similar pushback against the prospect of severe re-tightening in financial conditions appears warranted – the Reserve Bank of New Zealand's commentary last week a case in point. European policymakers' affirmations that the Fed easing first is not a necessary condition for the commencement of their own policy cycles should have a similar effect. The next two weeks will bring a good test of whether markets can price in policy de-synchronisation.

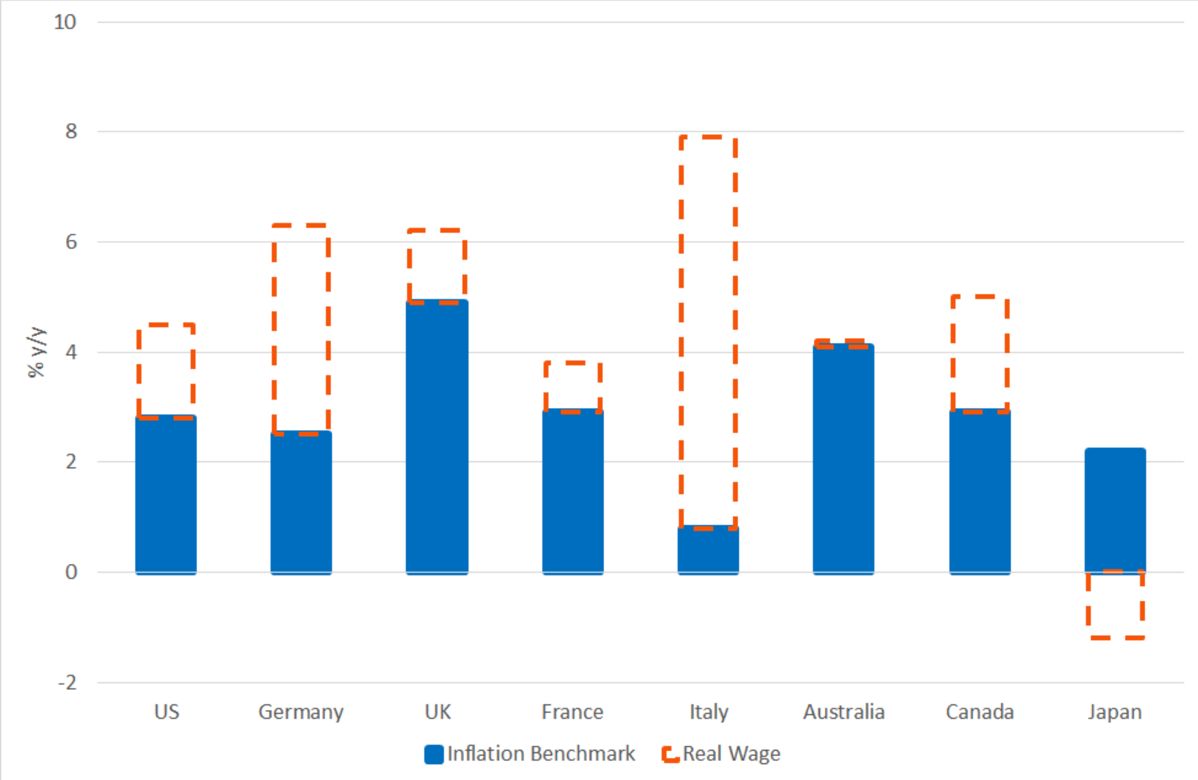
Exhibit #1: Change In Year-End Cuts Pricing, January-March



Source: Bloomberg, BNY Mellon

The main criteria for rate cuts remains real wage growth and its underlying dynamics. Even with most countries' inflation levels above target, we can see in exhibit 2 that real wages remain flat or positive in the G7; Japan is the economic and policy exception. Based on the latest nominals and deflators, dispersion is material but the consumption-inclined economies of the US and UK fall within the lower end of the range. Germany and Italy continue to enjoy materially positive wage real wage growth, but their import and consumption data have not indicated any corresponding strength. We think it telling that on Friday, Germany announced a new fiscal package – against the country's budgetary orthodoxy – worth 0.15% of GDP and with demand support in mind. However, as this is to be done through tax relief, the multiplier effect is likely to be muted. We continue to see a risk that fully waiting for the real wage gap to close, or even inflation falling back to target, before cutting rates risks scarring in other parts of the economy. As BoE Chief Economist Huw Pill stated on Friday, keeping policy "restrictive does not mean leaving" unchanged policy rates, suggesting a more dynamic rate-setting process can emerge as an option.

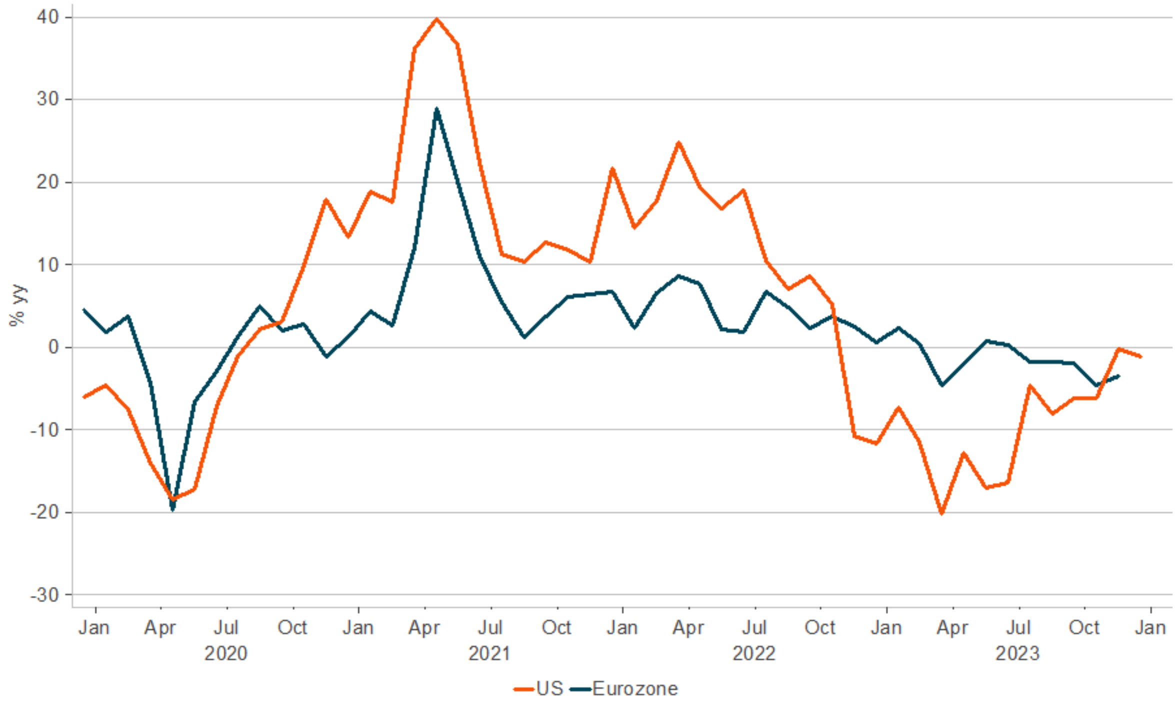
Exhibit #2: Major Economies' Real Wages



Source: Macrobond, BNY Mellon

Pill emphasised that even though disinflationary forces had not yet emerged, economic activity was weak in the UK. We recently highlighted that in the Eurozone, import data across geographical, classification and end-user breakdowns were all contracting, indicating similarly weak activity and demand. However, if there is one point of divergence across the Atlantic leading to re-pricing of the Fed, then it is in household demand. Exhibit 3 illustrates changes in import growth for consumer goods – the contrast is clear. A high global base from reopening demand in 2022 meant that 2023 was always going to be a year of annualised contraction in household demand growth, but the US household has displayed far more cyclical behaviour, and a return to expansion in 2024 looks likely. In contrast, momentum in Eurozone growth has not changed. Moreover, the decline is starting to look structural, even with positive real wage growth. The risks to inflation divergence – especially core items – will also be a factor in de-synchronisation over the next few quarters.

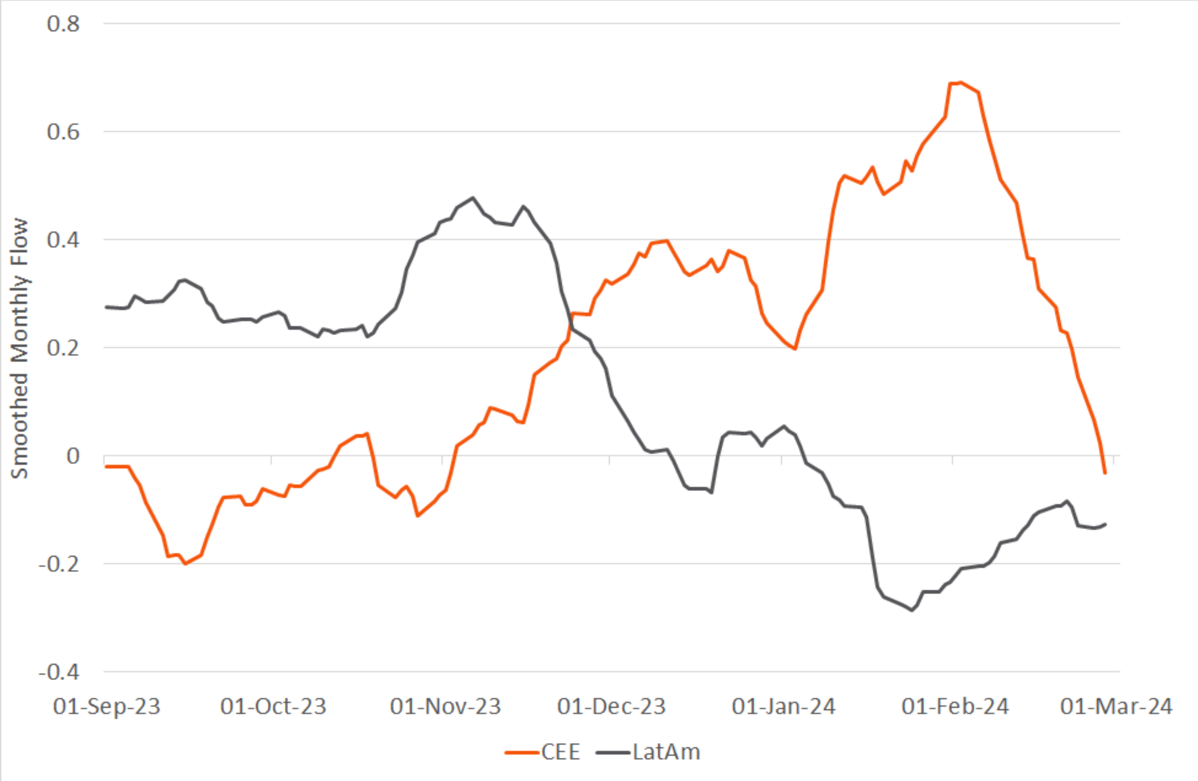
Exhibit #3: Consumer Goods Import Growth



Source: Macrobond, BNY Mellon

If easing expectations return to the market fold, we expect the carry trade to also struggle. Even though iFlow Carry climbed back to positive statistical significance in February, we believe the foundations are weak, especially with the likes of TRY and ZAR driving the flow. Meanwhile, there was near-capitulation flow in low-yielding Asia currencies, triggered by the initial gyrations in China's equity markets. With Beijing set to announce new stimulus measures this week at the National People’s Congress, high-carry regions such as Latin America and Central and Eastern Europe continue to see flow weakness due to their own easing cycles and/or dollar strength. We think FX preferences stand to shift – savings-heavy funders in Asia could start to realise some valuation gains. We would pay particular attention to how CNY and JPY react to any reflation impulse in the region.

Exhibit #4: CEE And LatAm Flow



Source: BNY Mellon

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