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Written by Andy Cates

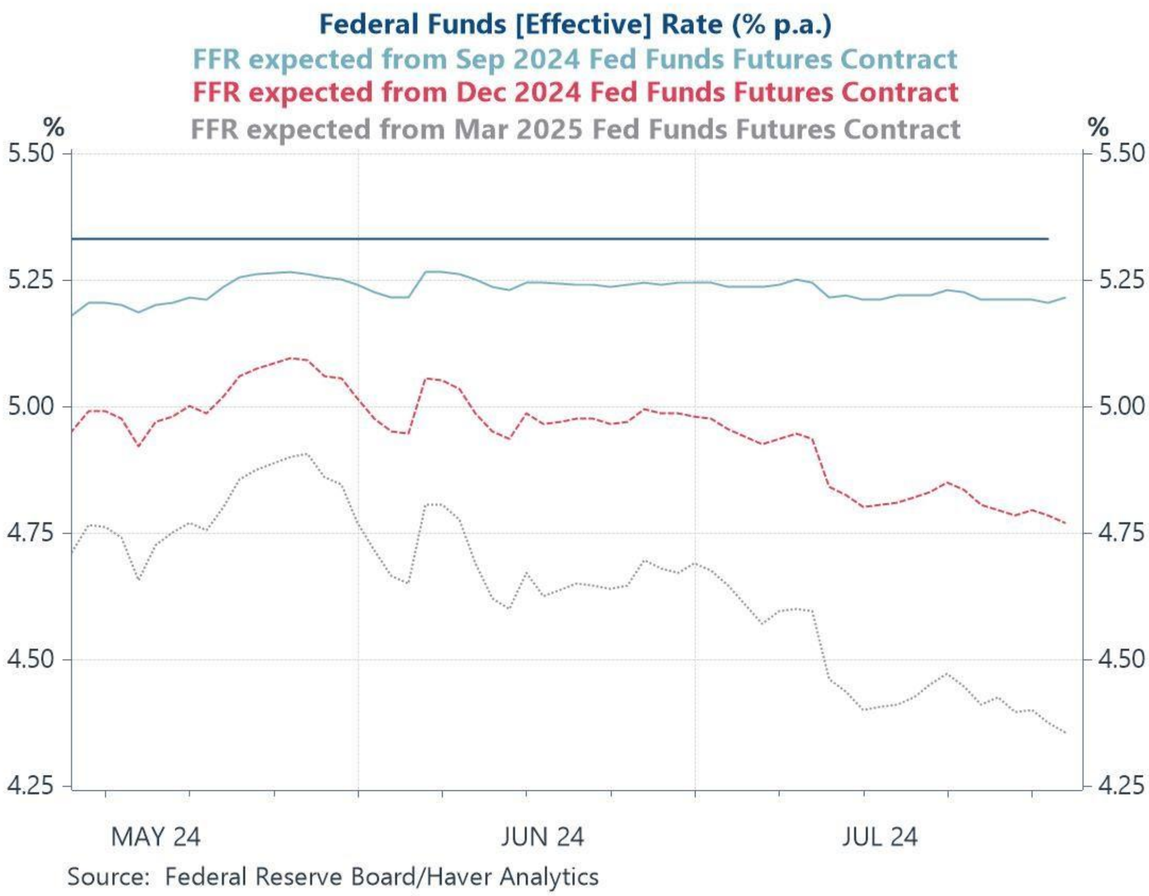
One up, one down, one no change

Monetary policy normalisation has been a big theme over the past few days and, insofar as this signals that inflation is also returning to more normal levels, this ought to have been welcomed by global investors. Most importantly the Fed has signalled a high likelihood that it will cut its policy rate at its next scheduled meeting in September and, in doing so, kick start an easing cycle (see chart 1). The Bank of England, in the meantime, has cut its policy rate by 25bps this week, a little earlier than some market participants had anticipated (chart 2). And on the other side of the equation, the Bank of Japan also sprung a surprise by unexpectedly lifting its policy rate and announcing a new plan to taper its bond buying programme (chart 3). While the timing of these communications and policy shifts has caught some analysts by surprise, there has been little to dislodge the view that most major central banks will embark on – or extend – an easing cycle over the next few months (chart 4). And this, coupled with recent evidence suggesting that labour market activity is softening and that inflation is subsiding, is reinforcing a soft landing narrative (chart 5). All that aside there is no shortage of factors that are challenging this narrative. Incoming data from many major economies, including Japan, for instance have disappointed consensus forecasts to the downside in recent weeks. And, having been highly dependent on the weakness of the yen, and amidst that economic weakness, Japan's equity market has lately suffered very sharp falls as its currency has reversed direction Another risk factor, however, concerns the further flare-up of instability in the Middle East in recent days, which might amplify supply chain pressures and lift global energy prices in the period ahead (chart 6).

US interest rate expectations

Although the Fed left its key policy rate unchanged in a range of 5.25% to 5.5% this week, Fed Chair Powell said that a rate cut in September is “on the table.” This, in turn, left market participants more confident that a 25bps rate cut could be enacted at the next meeting. Looking ahead investors have, on the whole, priced in slightly more interest rate easing from the Fed over the next 12 months during July and when contrasted with the previous two months (see chart 1 below). Disappointing US growth data (a Q2 GDP report being an exception) coupled with Fed-friendly inflation outcomes are the key reasons.

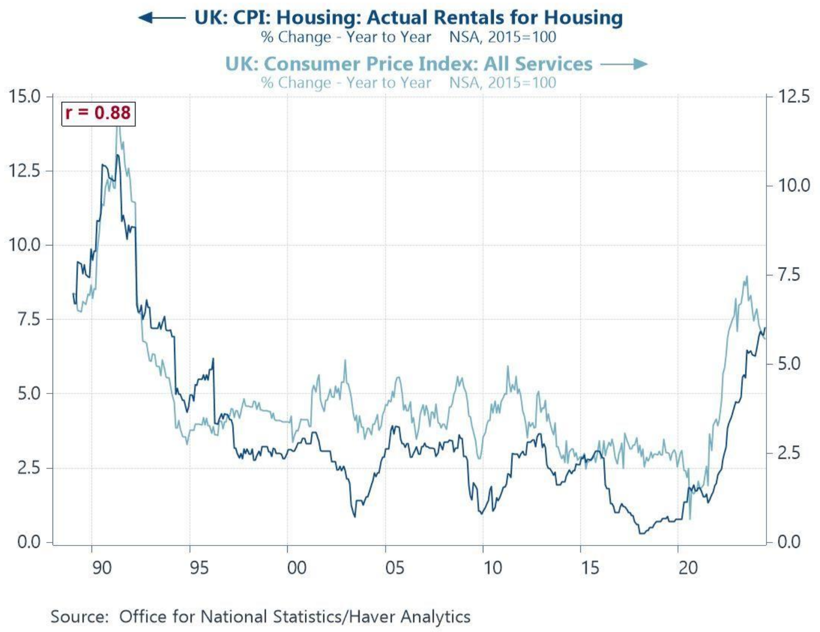
Chart 1: Expected level of the Fed Funds rate derived from Fed Funds futures contracts



UK services inflation and housing costs

This week’s decision by the Bank of England to cut interest rates by 25bps wasn’t universally expected – or voted for by MPC members - but nevertheless in line with the consensus view of UK economists. One of the key uncertainties about the decision concerned sticky service sector inflation and elevated wage pressures. Still, there are grounds for thinking that lower interest rates might, somewhat counterintuitively, help reduce service sector price pressures going forward. That’s because of the strong link in the UK between interest rates, housing costs (e.g. rents), and wage demands (chart 2).

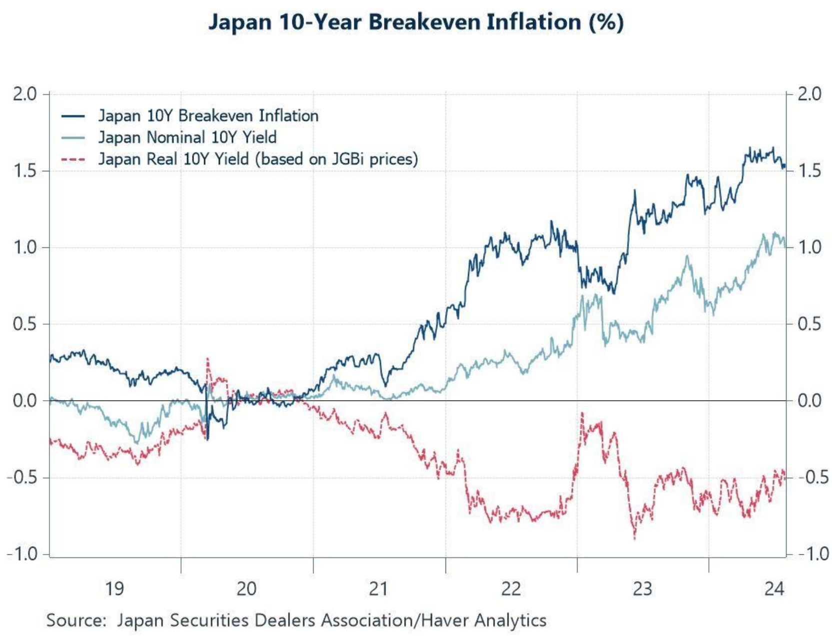
Chart 2: UK services versus rental CPI inflation



Market-based inflation expectations in Japan

In the other direction, the Bank of Japan's (BoJ) decision this week to raise its policy rate to "around 0.25%" from its previous range of 0% to 0.1% was also unexpected by some economists and market participants. Coupled with a plan to taper its bond buying program, this suggests greater confidence from policymakers about the economy's resilience (notwithstanding recent weakness) and a firmer commitment to normalize monetary policy. Haver's new calculations certainly suggest that market-based measures of inflation expectations in Japan have been rising in recent months. Our derived 10-year breakeven inflation measure specifically surpassed the 1.5% mark earlier this year. These firming expectations come as Japan has seen consumer price pressures begin to build.

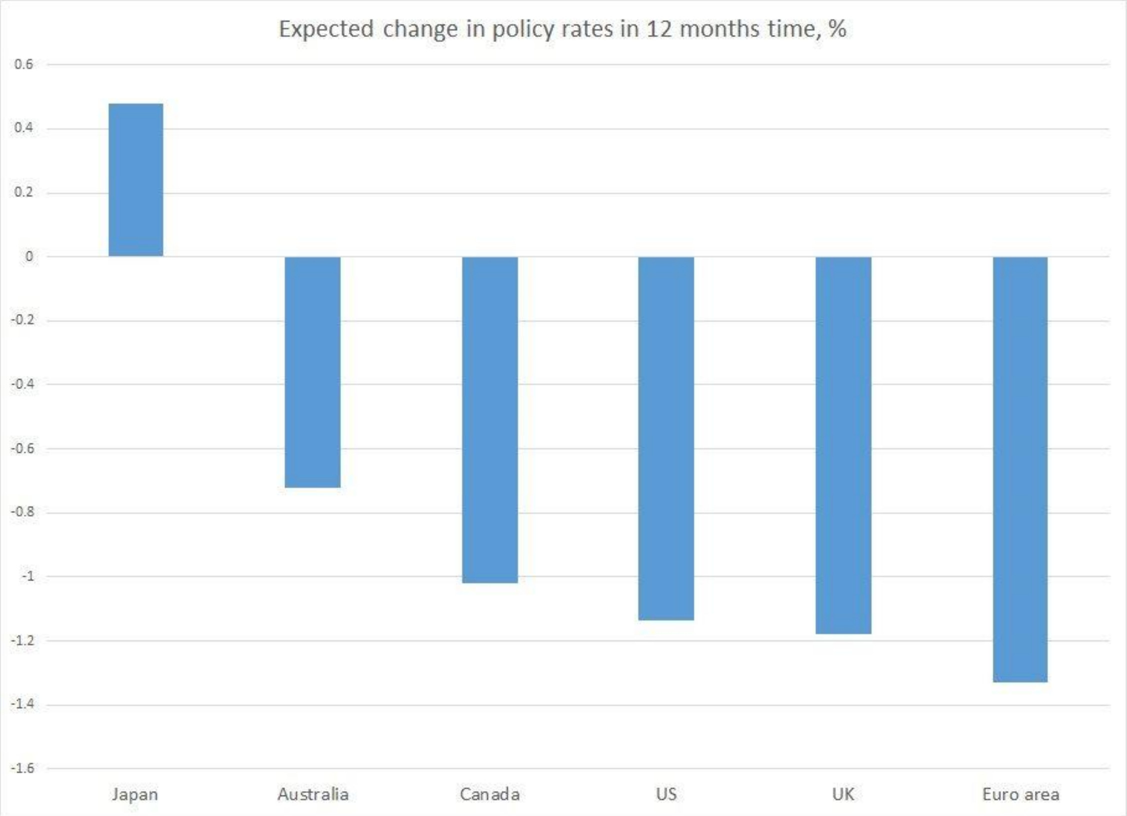
Chart 3: Haver's calculations for the 10-year breakeven inflation rate in Japan



The global interest rate consensus

Against this monetary policy backdrop, the latest Blue Chip Financial Forecasts survey suggests high confidence that a global easing cycle will be extended in the months ahead. Latest forecasts, for example, suggest that the Fed, the ECB, BoE and BoC will lower their policy rates by at least 100bps over the next 12 months. In the case of the ECB, the BoE and the BoC, this will follow cuts of respectively 25bps, 25bps and 50bps that have already been enacted. The BoJ remains an outlier in this narrative with expectations centered on a further cumulative increase in policy rates of 48bps over the next 12 months (which includes the 15bps increase in policy rates that was enacted this week).

Chart 4: The latest Blue Chip Consensus: Expected changes in policy rates over the next 12 months

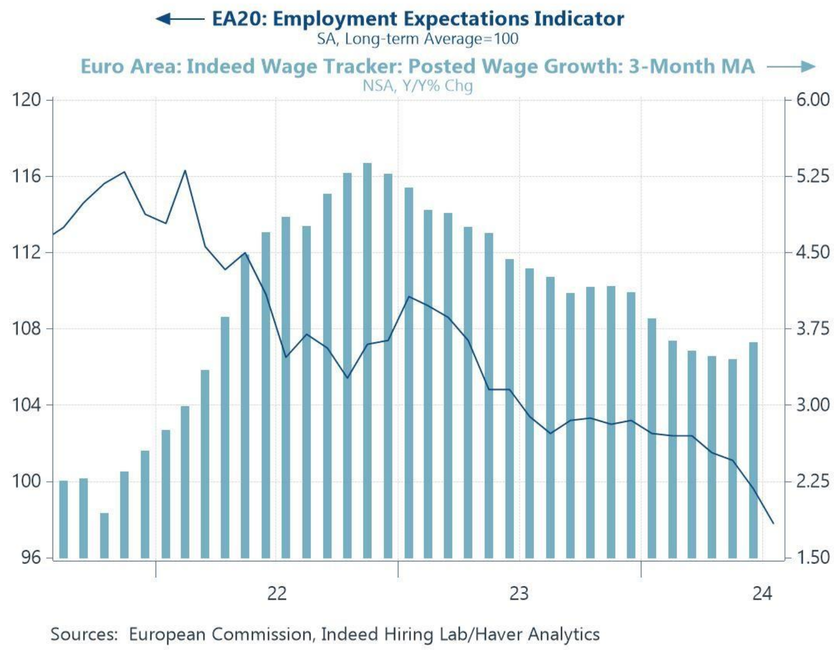


Source: Wolters Kulwer, Haver Analytics. Note that the Blue Chip Financial Forecasts Survey was conducted before the policy rate decisions from the Bank of Japan on July 31st and the Bank of England policy decision on August 1st.

Labour market weakness in the euro area

One reason why Blue Chip panelists are arguably sanguine about the prospects for interest rate cuts from most of the world's major central banks concerns labour market activity. Evidence has certainly been accumulating in recent weeks to suggest that this activity is weakening in both the US and Europe and that wage pressures are beginning to ease as well. This week's EC survey of business and consumer confidence, for instance, revealed a steep decline in companies' employment expectations in July. The Indeed hiring company's measure of private sector wage growth has additionally been slowing for most of the past two years.

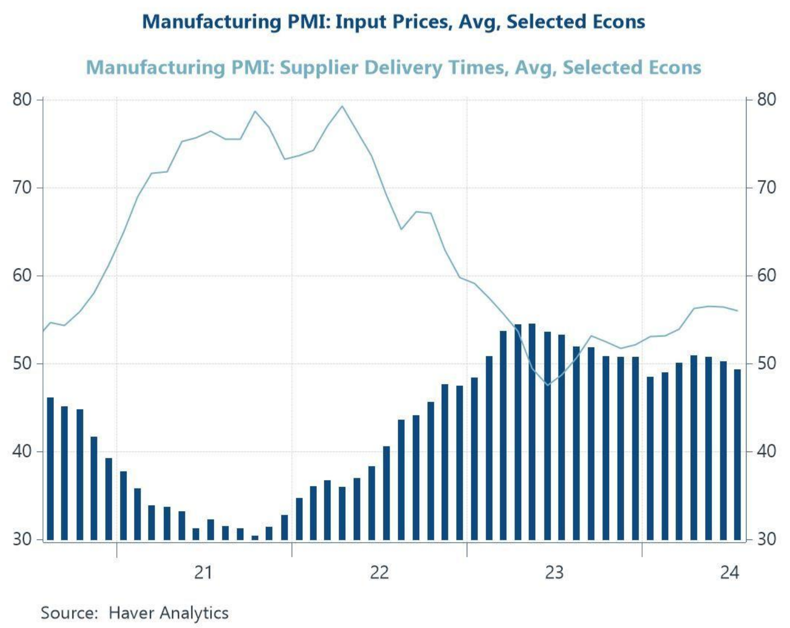
Chart 5: EC Survey’s employment expectations balance versus Indeed’s EA wage growth tracker



Geopolitical instability and supply chain pressures

A key risk that’s now challenging the soft landing consensus, at present, concerns the further flare-up of instability in the Middle East. That’s been triggered by an escalation of tensions between Israel and Hezbollah in Lebanon. But even before this, there had been heightened concern about how broader regional instability was disrupting supply chains. That being said, this week’s PMI surveys of manufacturing activity didn’t reveal any material tightening of supply chain pressures. In chart 6 below we have plotted an unweighted average of the supplier delivery times component and input price gauges from the surveys for the euro area, the UK, US (from the flash survey), South Korea, Japan and China (from the official survey). Collectively these do not yet suggest any reason for meaningful concern.

Chart 6: Manufacturing PMIs: Supplier delivery times and input prices



About the author

Haver Analytics is pleased to bring [Andrew Cates's] commentaries on the state of the global economy to its clients.

Andy Cates has more than 25 years of experience forecasting the global economic outlook and in assessing the implications for policy settings and financial markets. He has held various senior positions in London in a number of Investment Banks including as Head of Developed Markets Economics at Nomura and as Chief Eurozone Economist at RBS. These followed a spell of 21 years as Senior International Economist at UBS, 5 of which were spent in Singapore. Prior to his time in financial services Andy was a UK economist at HM Treasury in London holding positions in the domestic forecasting and macroeconomic modelling units.

He has a BA in Economics from the University of York and an MSc in Economics and Econometrics from the University of Southampton.

Data featured in this commentary:

Chart 1: Expected level of the Fed Funds rate derived from Fed Funds futures contracts
Series 1: FFED@DAILY
FFED@DAILY [Federal Funds [Effective] Rate (% p.a.)]
Series 2: (100 - BFFU24S@FFUTURES)
100
BFFU24S@FFUTURES [CBOT: 30-Day Fed Funds Futures Sep 2024 Contract: Settlement Price (100-FF Rate)]
Series 3: (100 - BFFZ24S@FFUTURES)
100
BFFZ24S@FFUTURES [CBOT: 30-Day Fed Funds Futures: Dec 2024 Contract:Settlement Price(100-FF Rate)]
Series 4: (100 - BFFH25S@FFUTURES)
100
BFFH25S@FFUTURES [CBOT: 30-Day Fed Funds Futures: Mar 2025 Contract: Settlement Price(100-FF Rate)]

Chart 2: UK services versus rental CPI inflation
Series 1: yryr%(D7CE@UK)
D7CE@UK [UK: CPI: Housing: Actual Rentals for Housing (NSA, 2015=100)]
Series 2: yryr%(D7F5@UK)
D7F5@UK [UK: Consumer Price Index: All Services (NSA, 2015=100)]

Chart 3: Haver's calculations for the 10-year breakeven inflation rate in Japan
Series 1: R158FBV@INTDAILY
R158FBV@INTDAILY [Japan: 10 Year Breakeven Inflation Rate (% p.a.)]
Series 2: R158KA@INTDAILY
R158KA@INTDAILY [Japan: 10-Year Government Bond Yield (% p.a.)]
Series 3: R158QA@INTDAILY
R158QA@INTDAILY [Japan: 10 Year Real [JGBi] Government Bond Yield (% p.a.)]

Chart 4: The latest Blue Chip Consensus: Expected changes in policy rates over the next 12 months
Please refer to the Excel file included in the VG3 folder download

Chart 5: EC Survey's employment expectations balance versus Indeed's EA wage growth tracker
Series 1: E025EEI@EUDATA
E025EEI@EUDATA [EA20: Employment Expectations Indicator (SA, Long-term Average=100)]
Series 2: I025YMA@EUDATA
I025YMA@EUDATA [Euro Area: Indeed Wage Tracker: Posted Wage Growth: 3 Month MA (NSA, Y/Y% Chg)]

Chart 6: Manufacturing PMIs: Supplier delivery times and input prices
Series 1: (((((S112MD@MKTPMI + S534MD@MKTPMI) + H111MMD@MKTPMI) + S542MD@MKTPMI) + S158MD@
S112MD@MKTPMI [UK PMI: Manufacturing Suppliers' Delivery Times (SA, 50+=Contraction)]

S534MD@MKTPMI [India PMI: Manufacturing Suppliers' Delivery Times (SA, 50+=Contraction)]
H111MMD@MKTPMI [US PMI: Mfg Suppliers' Delivery Times [Flash] (SA, 50 +=Contraction)]
S542MD@MKTPMI [Korea PMI: Manufacturing Suppliers Delivery Times (SA, 50+=Contraction)]
S158MD@MKTPMI [Japan PMI: Manufacturing Suppliers' Delivery Times (SA, 50+=Contraction)]
S023MD@MKTPMI [HCOB Euro Area PMI: Manufacturing Suppliers' D

Series 2: ((S924VMPI@EMERGEPR + ((((H111MMPI@MKTPMI + S542MPI@MKTPMI) + S158MPI@MKTPMI) + S
S924VMPI@EMERGEPR [China: PMI: Manufacturing Input Prices (SA, 50+=Expansion)]
H111MMPI@MKTPMI [US PMI: Manufacturing Input Prices [Flash] (SA, 50 +=Expansion)]
S542MPI@MKTPMI [Korea PMI: Manufacturing Input Prices (SA, 50+=Expansion)]
S158MPI@MKTPMI [Japan PMI: Manufacturing Input Prices (SA, 50+=Expansion)]
S112CMPI@MKTPMI [UK PMI: Consumer Goods Mfg: Input Prices (SA,50+=Expansion)]
S023MPI@MKTPMI [HCOB Euro Area PMI: Manufacturing Input Prices (SA, 50+=Expansion)]
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For more info on our data offerings please email sales@haver.com