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Bevan Graham
Salt Economist

Are we there yet?

A bit like an impatient child in the back seat of the car on a long interminable road trip, anxiously anticipating the hopefully imminent arrival at the destination, markets are anxiously anticipating the peak in interest rates, and signals that rate cuts may soon follow.

Most times, in both situations, a simple "no" is probably the best answer. It's hard to anticipate road delays (in the case of the child) and surprisingly robust labour market reports (in the case of markets) that might derail an attempt at a more specific response.

The actual answer for markets is a bit more nuanced. While inflation has peaked, growth is slowing, and all major central banks have slowed the pace of rate hikes recently, there is no greater certainty about where the peak will ultimately prove to be.

All we can really conclude at this point is that the bulk of the work is done and that we are now at the point in the cycle where each central bank decision itself becomes more nuanced, data dependent and where greater judgment needs to be applied.

The difficulty is the lags. In much the same way the child may have no concept of time and "in half an hour" doesn't wash it, central banks don't see the impact of their actions immediately. Those lags can be 12-months or longer and are longest in the labour market, where the most potent inflation forces currently reside.

Signs we're nearly there…

Inflation has peaked in most developed countries around the world, except maybe in Australia where the annual inflation rate recently hit a fresh high. This is a function of generally lower commodity prices, repaired supply chains leading to reduced delivery times and lower shipping costs, all contributing to lower prices for goods.

Higher interest rates are also starting to bite into activity. Household spending is softening as mortgage interest rates have surged higher and house prices have fallen. Residential construction activity is also softening in many countries.

Higher mortgage rates will continue to impact on activity, even if there is no further tightening, as some households are yet to move off significantly lower fixed-rate mortgages.

The bottom-line is that most developed economies will be in or flirting with recession this year.

…or perhaps not.

Since the early days of the pandemic, the inflation problem has morphed from one borne of broken supply chains and higher commodity prices impacting on goods prices, to a problem of tight labour markets and high wage inflation leading to more generalised inflation including the price of services.

It's this part of the inflation equation that is more a consequence of local demand and supply conditions, rather than global forces, over which domestic monetary policy has greatest influence.

However, in general, labour markets remain tight.

In the United States, employment growth has slowed

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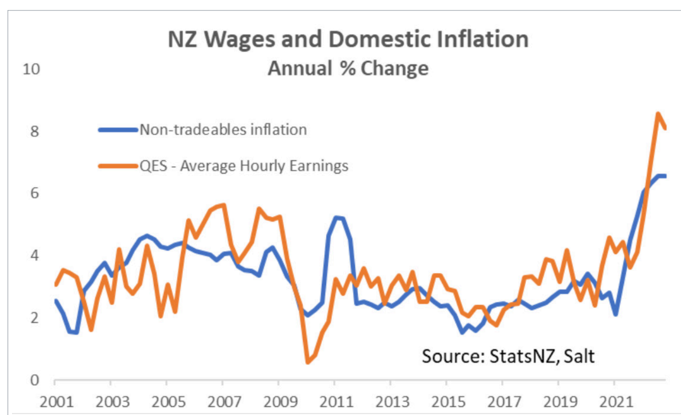
though latest data showed payrolls growth running at 3-times the expected rate in January, while the unemployment rate declined to a 53-year low. The good news is that despite the stronger employment growth, annual wage inflation moderated, though it remains in excess of a level that could be considered consistent with 2% inflation.

Here in New Zealand, latest labour market data points to some softening in conditions. In the December quarter of last year, employment growth slowed, the unemployment rate rose, and wage growth came in softer than expected with signs the annual rate of increase in nominal wages may have peaked.



So, are we there yet?

No, but we are getting closer to a pause, and some central banks are closer than others.

The Bank of England is probably closest to being done. The BoE hiked 50bp at their last meeting in early February, but the tone from the meeting implied they are closing in on the peak. Revised forecasts show the economy in recession and inflation falling below the target level in the second half of next year. A final 25bp hike in March is possible, but not guaranteed.

The European Central Bank also hiked 50bp in February, though President Lagarde made it quite clear there is more to come. Another 50bp seems assured for March, though by May we expect there will be more evidence of the desired slowdown in activity and core inflation pressures.

In the United States, the Federal Reserve hiked 25bp in February, a step down from the 50bp in December which was itself a step down from the string of 75bp hikes last year. Powell's post-meeting comments that disinflation was well underway were interpreted dovishly by the market, though the strength of the January employment report and further comments from Jay Powell (or even a more careful read of his first comments!!) indicated the FOMC is not done yet. We expect a further two 25bp hikes with a pause at 5.00-5.25%.

The Reserve Bank of Australia turned more hawkish in February. A higher-than-expected December quarter CPI out-turn was the catalyst. While they hiked the expected 25bp, markets and analysts have priced in up to two more hikes with the RBA expected to stop at 4.1%.

The Reserve Bank of New Zealand a delivered a super-hawkish Monetary Policy Statement at their last outing in November last year. They delivered a hike of 75bp, their largest ever, disclosed they had considered hiking 100bp and lifted the projected terminal rate from 4.1% to 5.5% - much more than expected by markets. But since the start of the year, we have now seen a softening in some activity indicators, a lower-than expected inflation result and now early signs of a weakening in the labour market.

That combination of factors leads us to believe that while the RBNZ still has more work to do, it might not have to do as much as they flagged in November. Furthermore, consistency argues that the recent lower than expected inflation out-turn should see a lower forecast terminal rate, just as higher than expected inflation has resulted in increased projections for the terminal rate. We expect a 50bp hike to 4.75% in February followed by a final 25bp in April for a pause at 5.0%.

Bit more work to do, early cuts unlikely

So, there is a bit more work to do but most central banks will pause soon.

The labour market remains key. Regular readers will recall during the transitory vs persistent inflation debate, we argued that there will be elements of both in the period that lay ahead at that point.

Higher goods price inflation borne of supply chain disruption, higher commodity prices and the war in Ukraine would prove transitory. All that was at question was how high and how long?

But we also saw tighter labour markets and higher wage inflation ahead, which would lead to more generalised inflation pressures and would ultimately prove more persistent.

If central banks have got it right, the upcoming pause will also be the peak. But if activity, the labour market and, most importantly, inflation fail to play out as expected and come in stronger, hikes may need to resume. Of course, activity, wages and inflation could all play out softer than forecast and expectations of rate cuts could be brought forward.

We urge caution on assuming lower inflation by itself could lead to early interest rate cuts. While falling goods prices may see headline inflation returning to target more quickly than expected, central banks will only move to cut rates when they see a broader set of macro-economic

conditions that suggest the return of inflation to target is likely to be sustained. That means more balanced demand and supply conditions in the economy, but particularly in the labour market.

Most importantly, wage inflation also needs to fall to a level that is consistent with target inflation. While wage inflation has softened in some countries, it still has a way to fall to be consistent with 2% inflation. There is still a possibility the decline in wage inflation gets stuck somewhere along the way, and a risk that a premature easing of monetary conditions could lead to a resurgence in wage inflation.

We think it will be 2024 before central banks have sufficient confidence that the battle against the causes of the persistent part of inflation has been won and move to cut interest rates.

Don't forget the structural forces

At the same time, there are several structural forces bubbling away under the surface. We have written about these before and won't repeat in full here, but these include the retreat of globalisation, the waning of China as a global disinflationary force, ageing populations combined with moribund productivity growth, easy fiscal policy, and broader structural changes in the labour market, a factor Jay Powell alluded to in his comments last week.

That means that when there is scope for interest rate cuts, those cuts may be limited by these structural forces. This in turn means neutral monetary policy rates may be higher in the next cycle that those that prevailed pre-pandemic, but more on that story over the next few months.

For markets, the fluctuating weight of evidence is leading to uncertain directions in global bond yields, which now seem to be stabilising at slightly higher levels, and thus, reflect some unwinding of the earlier market optimism that easier monetary policy and markedly lower inflation are imminent. This may persist for a few months longer, in our view, with implications for the more interest rate sensitive parts of equity markets.

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