SALT INSIGHT

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Take it Easy

We are close to the start of major central banks starting to ease monetary conditions. Some second-tier central banks have already started the process, including Sweden's Riksbank and the Swiss National Bank. More significantly, the next cab off the rank is likely to be the European Central Bank which sent a clear message in April that their intention was to make their first interest rate cut in June.

Other central banks are poised to follow later this year or in early 2025. It's no surprise that the early banks to cut are in economy's where inflation has moved fastest back towards target, but also where growth and labour market dynamics have led their central banks to assess that progress will continue and, most importantly, be sustained. The outlier amongst developed market central banks is the Bank of Japan where policy normalisation has started, and further hikes are likely as other central banks cut.

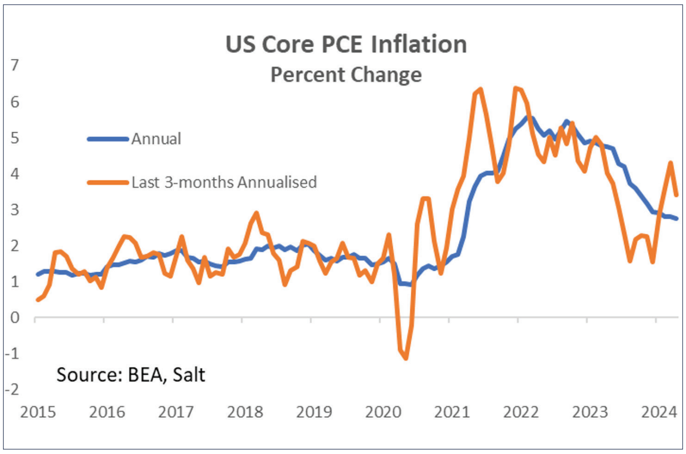
This note takes a brief look at each of the world's major central banks (plus a couple that are major for us - Australia and of course New Zealand) and how we see monetary policy evolving from here for each of them.

United States

There has been a wide swing in market expectations for US Federal Reserve cuts this year. At the turn of the year seven cuts in the Fed funds rate were priced in starting in March. This was spurred by a run of lower-than-expected inflation at the end of 2023 and a flawed (in our view) Federal Open Market Committee (FOMC) statement in December which became a red rag to an interest rate bull. That has mostly reversed out as inflation started to print above expectations through the March quarter, while growth and the labour market showed remarkable resilience. Markets are now pricing between one and two cuts before the end of the year.

There are some obvious parallels between recent developments in the United States and here in New Zealand. In both countries, recent high levels of immigration have supported growth in activity and labour market supply. In the US's case, breakeven employment growth (the level of employment growth that keeps the unemployment rate unchanged at a stable participation rate) is now around 265k per month (Morgan Stanley Investment Management estimate), significantly higher than the long run average of around 70-90k per month. Furthermore, the positive supply shock has allowed growth in consumption and employment to continue, even as wage growth and inflation have moderated, albeit slowly.

The recent run of data for the month of April has been more helpful. Payroll employment growth slowed to 175k, the unemployment rate rose, and wage growth moderated further. Retail sales came in flat in and CPI inflation printed in line with expectations after several upside surprises. The core Personal Consumption Expenditure deflator (core PCE), the FOMC's preferred inflation gauge, came in at +0.2% in April. That was the lowest monthly result in four months and reduced the 3-month annualised from 4.3% in March to 3.4% in April.



We think the annual rate of core PCE inflation continues to moderate from here but given the upside surprises through the first quarter of the year, the next Summary of Economic Projections (SEP) to be published at the next FOMC meeting in June will likely show an upward revision in year-end core PCE inflation expectations. That should also see the median expectation for monetary policy pulled back from three 25bp cuts in 2024 to two. We think the more recent weaker activity data will likely prevent that from being pulled back even further, as was the risk just a couple of weeks ago.

Once they start, we expect the Committee will take a gradual approach and only cut rates at meetings at which fresh SEP forecasts are published (March, June, September, and December). The two cuts this year are therefore likely to come at the September and December meetings. We are taking FOMC Chairman Jerome Powell at his word that the November election won't impact the timing of rate cuts. Further out we see four cuts next year, taking the Fed funds to 4.0% at which point we expect the Committee to pause and take some time to let the data catch up and reassess the outlook.

Euro area

Despite coming a bit late to the rate hiking party, we think the ECB will be the first major central bank to cut interest rates this cycle. That's because growth has been weak, admittedly in part due to geo-political factors and the fallout in energy markets, and inflation has fallen far more convincingly than elsewhere.

The annual rate of headline inflation peaked at 10.6% in October 2022 and had fallen to 2.6% by May this year. Annual core inflation has nearly halved since peaking at 5.6% in June 2023, coming in at 2.9% in May. The slower progress on core inflation is symptomatic of stickier inflation in the labour-intensive services sector. While this is not just a Europe issue, wage growth peaked in 2023 and the ECB is showing greater confidence the downward momentum in wages and thus core inflation will be sustained.

The ECB's Governing Council gave a clear hint in April that a rate cut was imminent, and we expect a 25bp cut at this week's June meeting. Beyond that the ECB has not indicated a clear path ahead for rates. We expect a gradual approach with rate cuts only likely at projection meetings, as in the US. In between times, the ECB will be keeping a close eye on wages, profits and productivity.

We expect three cuts this year, followed by four next year. That will take the deposit facility rate (DFR) to 2.25% by the end of next year.

United Kingdom

Late change here. We thought the Bank of England was in line to cut interest rates along with the ECB in June. The April inflation result was an upside surprise, both in core goods and, more importantly, core services. That likely pushed the first rate cut out to September.

Momentum in inflation had been looking very soft since last August. Headline inflation at 2.3% is now at its lowest level since July 2021. Softer inflation, combined with sizeable base effects, was expected to push headline inflation to below 2% y/y in May and June. While this was likely to prove temporary, inflation was expected to settle around 2% over time.

After peaking at 7.1% y/y in May 2023, core inflation has since slowed to 3.9% in April. While great progress has been made, the upside surprise in April came in service sectors that are sensitive to the National Living Wage. That has poured some cold water on the BoE's wage assumptions. Softer wage growth is a necessary condition for continued core disinflation next year.

While it's never a good idea to read too much into one number, we expect the Monetary Policy Committee will want to see another couple of CPI prints before moving. That means a September start is most likely, but in the spirit of not reading too much into the April result, we continue to expect the BoE to cut its policy rate to 3.5% next year from 5.25% currently.

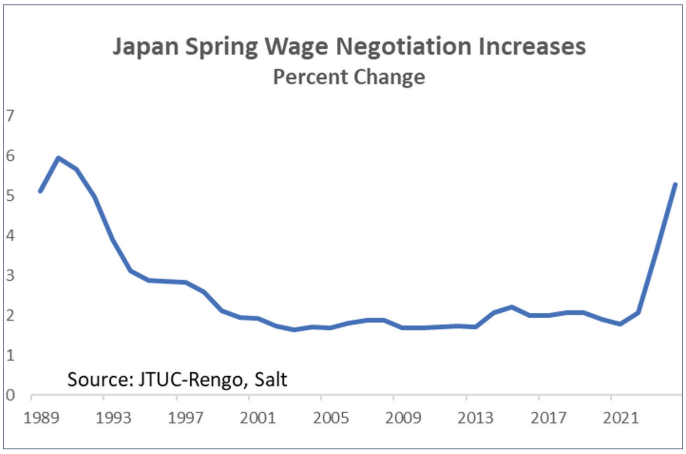
Japan

The Bank of Japan (BoJ)remain the odd one out amongst developed central banks. After the removal of both the negative interest rate policy and yield curve control in March, we see further interest rate increases as inflation expectations continue to grind higher.

Japan's economy has had a structure shift in equilibrium, away from stagnation and deflation to a nominal growth regime with a virtuous cycle in wages and prices.

Japan's rapid growth is being driven by both domestic and foreign demand, and we believe it is outstripping potential growth. Consequently, we see a positive output gap for the first time in four years. Moreover, the labour market remains tight, with the BoJ's Tankan survey showing persistent employment shortages, particularly in the service sector.

Unsurprisingly, wage inflation has picked up. The spring wage negotiations for 2024 exceeded 5% the first time in 33 years. What started as higher inflation borne of higher commodity has morphed into a virtuous cycle of higher wages and inflation.



The positive feedback loop is broader, with a sustained surge in corporate profits allowing the wage gains to continue. These profits and the tight labour market have also spurred robust capital investment, further reinforcing the strong growth.

However, despite all these drivers, consumption spending continues to be lacklustre, and it remains the key risk to sustained reflation. This risk is reinforced by demographic headwinds. In our base case, we anticipate gradual strengthening in consumption as wage increases continue and spread. In addition, a forthcoming small income tax cut starting in June should provide further support for consumer activity.

We expect two further hikes in the magnitude of 15-25 basis points, the first in the third quarter of this year followed by another in the first quarter of 2025.

Australia

The Reserve Bank of Australia didn't tighten monetary policy as aggressively as we thought they would, or as much as other central banks. In doing so they have chosen a slower decline in inflation. This also leaves the disinflation process vulnerable to risks including later and less easing from other central banks, stimulatory fiscal policy and a more resilient labour market.

The good news for the RBA is that the labour market is softening, albeit only gradually. Forward looking labour market data is soft, which should be followed by increases in the unemployment rate over the remainder of this year and into 2025. Wage growth is likely to continue to moderate, though this will remain gradual.

April CPI data was stronger than expected, with the annual rate for headline and core increasing for a third consecutive month. Both goods and services contributed to the uplift. Despite the recent acceleration in most inflation measures over the last few months, the weaker activity points to a resumption in the disinflation process throughout the remainder of the year. However, we don't expect core inflation to be back inside the RBA's 2-3% target band until the second half of 2025.

There was a recent brief flirtation with the idea that the RBA may be forced to restart interest rate hikes. We think the bar to restart hikes is high. While we thought the RBA should have hiked more, monetary policy is in restrictive territory, but it will take longer for the disinflation process to play out. We see a first cut in the Australian cash rate in February 2025 with a total of three cuts. That will take the cash rate to 3.6%.

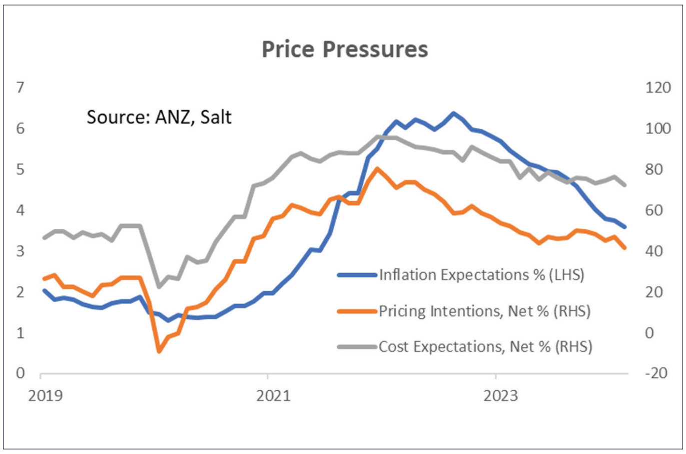
New Zealand

We find ourselves out on a monetary policy limb in New Zealand. We have retained our long-held view of a first cut in the Official Cash Rate (OCR) in November this year. At times that has had us at the hawkish end of the spectrum as market pricing has brought cuts forward, generally after weak activity data, and at other times at the dovish end as market pricing has pushed cuts out, generally after strong inflation data.

We are now firmly at the dovish end of the spectrum. That's based on a view that the economy is generally weaker than the RBNZ is expecting, and that the unemployment rate is likely to move higher than the RBNZ was projecting in their more hawkish than expected May Monetary Policy Statement (MPS). That leads us to believe that we are on the cusp of a meaningful reduction in wage and non-tradeable (domestic) inflation pressures.

Other factors forming part of that view is we believe the strong net inward migration flow is now slowing sharply as Covid catch-up runs its course but more importantly as employment conditions have deteriorated to the extent that will deter potential immigrants from coming to New Zealand. We also believe the recent Budget will not significantly shift the dial on growth or inflation pressures.

Furthermore, the latest ANZ Bank showed the net percentage of firms expecting to raise their prices fell to 41.6 in May. That's still too high, but the lowest level since December 2020. 72.6% are still reporting higher costs, but businesses appear increasingly unable to pass those on given flagging demand. That explains the fall in profit expectation, which appear on the wane again. This shows how tough the environment is for business right now, but it's good news for a central bank desperately seeking a reduction in firms' pricing power.



So, we expect a first cut of 25bp in November. The risk around that forecast is non-symmetrical in the sense that if we are wrong it will be later, not earlier. As with most of the central banks above, we expect the RBNZ will take a gradual approach and only ease at full MPS meetings, at least in early stages. We see the OCR being lowered to 3.5% during 2026.