

## Global: Fed and ECB still hawkish despite reducing rate hike pace

### ► US: Fed downshifts to 50 bps hike, as expected

The Fed slowed the pace of rate hikes to 50 bps to 4.5% (upper bound) at its 13-14 December meeting, but remained committed to reaching a higher terminal rate. The dot-plot estimate for 2023 has been raised to 5.25% (upper bound), from 4.75% in September, implying a potential additional 75 bps rate increase in the current hiking cycle. Chair Jerome Powell highlighted that the ongoing rate hikes are appropriate to reach sufficiently restrictive levels, but kept the option open for either a 25 bps or 50 bps increase in February. Our base case is for a 25 bps increase in February, followed by a similar magnitude hike in March and May, taking the terminal rate to 5.25%. However, we would not rule out the possibility of a 50 bps hike in February and a 25 bps increase in March to reach the same terminal rate. Powell also underlined that there is a need to keep rates steady at peak levels until the Fed is confident that inflation is softening in a sustained way. We believe that the Fed will likely keep interest rates on hold for at least two quarters after the peak rate is reached, assuming there is no sudden economic shock. This contrasts with the bond market which expects interest rate cuts to begin in 2H2023, immediately after the hiking cycle ends in 1H2022.

### ► US: Inflation forecasts revised up, growth projections cut

We believe the Fed would like to see hard evidence of both inflation and wage growth decelerating on a sustained basis before it begins a rate-cut cycle in 2023. A deceleration in inflation was already evident in the October and November CPI inflation readings, but is being driven mainly by energy and core goods prices. However, core service inflation still remained strong in November, excluding one-off effects. We believe that a deceleration in wage growth will also be key if core services inflation is to ease meaningfully. The Fed expressed concerns about a wage-price spiral as it would keep core inflation sustained at higher levels for a longer period. Against this backdrop, the FOMC revised up its inflation projections for 2023 and 2024, with core PCE inflation raised to 3.5% for 2023 (September: 3.1%) and 2.5% for 2024 (September: 2.3%). In terms of economic growth, real GDP growth was lowered to 0.5% for 2023 (September: 1.2%) and to 1.6% for 2024 (September: 1.7%). Powell, while noting that there tends to be economic pain while fighting inflation, flagged that "it's not knowable" if the US economy is heading for recession.

### ► Eurozone: ECB makes hawkish 50 bps hike in December

The ECB also raised its benchmark rates by 50 bps at its 15 December meeting, taking the main refinancing rate to 2.5% and the deposit rate to 2.0%. The size of the hike was in line with both our and consensus expectations but forward guidance was much more hawkish than market expectations. The ECB's guidance highlighted that interest rates will have to rise significantly at a "steady pace" to reach levels that are sufficiently restrictive. President Christine Lagarde flagged that a steady tightening pace means 50 bps hikes for

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“a period of time,” including February’s meeting. She also underlined that interest rates need to be raised to a level higher than market expectations prior to December’s meeting. We now expect the ECB to raise rates by 50 bps each at the February and March meetings, followed by an additional 25 bps hike in 2Q2023, taking the terminal deposit rate to 3.25%. We see risks to the interest rate outlook as tilted to the upside given the outlook for elevated inflation. On the balance sheet reduction side, the Governing Council announced the start of passive Quantitative Tightening (QT) from March 2023. The pace of the monthly average reduction will be EUR15.0 billion until the end of 2Q2023 and the subsequent pace will be determined over time. On the macroeconomic side, the new economic projections point to slower economic growth and higher inflation for 2023. The real GDP growth forecast is lowered to 0.5% for 2023, from the 0.9% estimate in September. Headline inflation is revised up to average 6.3% in 2023 (vs. 5.5% earlier) and 3.4% in 2024 (2.3% previously).

► **UK: BoE hikes by 50 bps but with slightly dovish tone**

The BoE also pared its rate hike increment to 50 bps at its December meeting, taking the benchmark rate to 3.5%. Six MPC members supported the 50 bps increase, two favoured an on-hold decision, whilst one member supported a 75 bps hike, highlighting the divisions within the committee. The forward guidance highlights a meeting-by-meeting approach and also reiterated the BoE’s willingness to “respond forcefully, as necessary”. The overall tone of the meeting was relatively dovish compared to previous meetings, in our view, in part due to two members voting to leave rates unchanged. The MPC highlighted that the combination of tight labour market conditions and the persistent inflation backdrop were key factors behind the 50 bps hike. We believe that the BoE will likely maintain its 50 bps hiking pace at February’s meeting, followed by an additional 25 bps hikes each at March and May’s meetings, taking the terminal rate to 4.5%. The MPC also refrained from providing any hints on what the terminal rate could be, keeping the market guessing. On the economic side, the BoE assessed that the policy measures announced in the Autumn Statement would “increase the level of GDP by 0.4% in one year’s time, leave it broadly unchanged at a two-year horizon, but reduce the level of GDP by 0.5% in three years’ time.” On inflation, the Energy Price Guarantee is expected to reduce short-term inflation by around 0.75 ppt.

*The next issue of Global Data Watch will be published on Monday 9 January 2023.*

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