Philip Milburn: Hawkish or dovish hikes

After the European Central Bank was hawkish last week (albeit only relative to expectations), focus turned to the widely predicted rate rises from the Federal Reserve and Bank of England.

On Wednesday, the Fed started its policy tightening journey with a 25 basis point rate hike. The hawkish surprises that arose were the increase to its inflation projections and a lurch upwards in the dot plot of future policy rate forecasts.

The Fed's median expectation for personal consumption expenditure (PCE) inflation (its preferred measure) in 2022 jumped from 2.6% to 4.3%; even by 2024, the rate is forecast to still be above target at 2.3%. It is clear that with rampant inflation and a hot labour market, monetary policy needs to be much tighter. The dot plots have shifted, with the median forecast now representing a further six rate hikes in 2022 and another three to four in 2023. To me, the most interesting part of the Fed's report was that it now has the Federal funds rate finishing both 2023 and 2024 at 2.8%, a level above its estimated neutral rate of 2.4%.

So, if (and it's a very big if) the Fed stays on its current rate hiking path, then it's going to take monetary policy into tight territory. This is something they have failed to achieve since the financial crisis. Furthermore, quantitative tightening (QT) will start in Powell's words "at a coming meeting". He estimates its impact will be the equivalent of another 25bps hike this year, taking us to seven plus one for the year as a whole.

We have been stating for a while that we believe that the neutral rate is somewhere in the 2.0% to 2.5% range and that the US economy could cope with this level, which would leave the long-term real neutral rate close to zero or possibly even in positive territory. Given the amount of debt outstanding around the world and in the US, base rates close to 3% would have a large impact on economic activity levels. The bond market's reaction has been a yield curve flattening: 10-year bond yields dipped briefly below those on the 5-year.

Finally, the Fed is showing its hawkish credentials and taking inflation seriously. For the first time, its forecasts are effectively ahead of the bond market. The market is assuming either the Fed cannot deliver all the planned hikes or that some will be rapidly unwound as a recession is created. I believe the US economy is strong enough for the Fed to get to neutral rates and unwind $3 trillion of QE. However, I doubt that a 2.8% Fed funds rate will be reached, let alone maintained.

Referencing Putin's war on Ukraine, the Fed stated: "the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity". The US does have a few advantages: being a small net energy exporter, being able to increase shale production, and being geographically distant from the war.

The UK does not share such advantages, so retail price inflation could now peak above 10%. It was anticipated that the headline peak in both retail price inflation and consumer price inflation would be in April, but if energy prices stay at elevated levels then October may represent the zenith as the Ofgem price cap increases for the February to August assessment period feed through.

Thus, the Bank of England faces a particularly acute policy trade-off, trying to put the inflationary genie back in the bottle at the same time as the UK consumer suffers a cost-of-living crisis. In its words, "developments since the February Report are likely to accentuate both the peak in inflation and the adverse impact on activity by intensifying the squeeze on household incomes". Clearly the latter factor has influenced the MPC members to a greater extent and the rate rise today was accompanied by dovish language.

The vote itself was eight to one, with Cunliffe the dissenter looking to hold rates steady. In my opinion, the taming of the hawks was more pertinent as four voters who previously wanted a 50bps hike found new comfort in their dovecotes. Rates markets have focused on the following sentence: "based on its current assessment of the economic situation, the committee judges that some further modest tightening in monetary policy may be appropriate in the coming months, but there are risks on both sides of that judgement".

Certainly, the pace of Bank of England rate rises will be slower than the market had forecast ahead of today's meeting. Inflation still needs to be conquered as there is the risk it becomes self-fulfilling through the feedback loop of corporate and consumer expectations, in particular wage inflation. It should be borne in mind that the Bank of England has said it can start QT once rates hit 1%, which is only one hike away. This gives them another tool, but it will still be a good few years until inflation is back down anywhere near target. The UK may be the one exception where the central bank actually has to create a recession to get inflation back to 2%.

The crux of the problem is that developed world monetary policy was kept too loose for too long and a blind eye was turned toward inflation. It is clearly not transitory and now rates have to go up further than they otherwise would have. Exogenous events, such as the energy price crisis, are beyond central bankers' control. But the monetary policy tightening journey would have been so much smoother if it had been started before inflation became embedded in expectations.

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