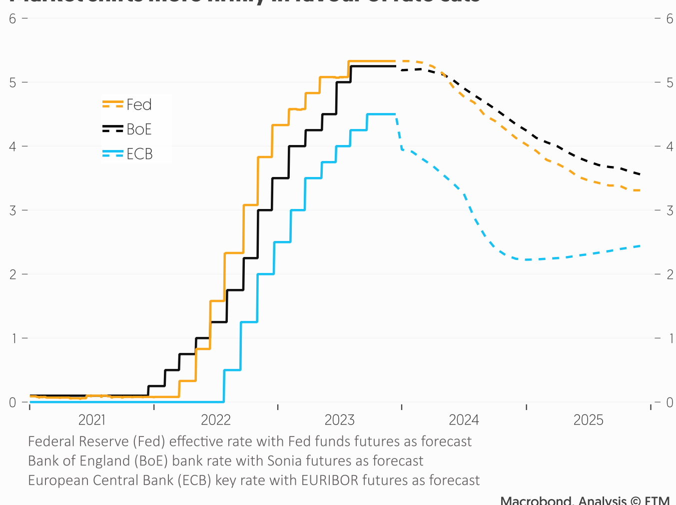
Fed leads central banks to turn more growth-sensitive

Key points

- The Fed surprised the market to become more growth-sensitive than many investors had anticipated. Although a lot had been priced in, and the market believed this to be the top of the interest rate cycle, few had expected the Fed to turn dovish and to build expectations of rate cuts. The interpretation is that the Fed needs to pivot towards easier monetary policy to ensure a soft landing.
- Numerous data points now allude to a shift in economic conditions that demand a shift in monetary policy dynamics. As the conditions manifest through H1 2024, the central banks may bring forward the timing of their rate cuts, but that will depend on whether inflation moderates to create room for them to do so and if growth softens sufficiently.

BASELINE VIEW: The Fed's surprise in turning dovish signals that the inflexion point is upon us and that rate cuts should begin through H1 2024, starting as early as March. This should be good news for the ZAR given that the SARB will likely be more conservative in its policy vs the Fed.

Fed leads major central banks in turning dovish

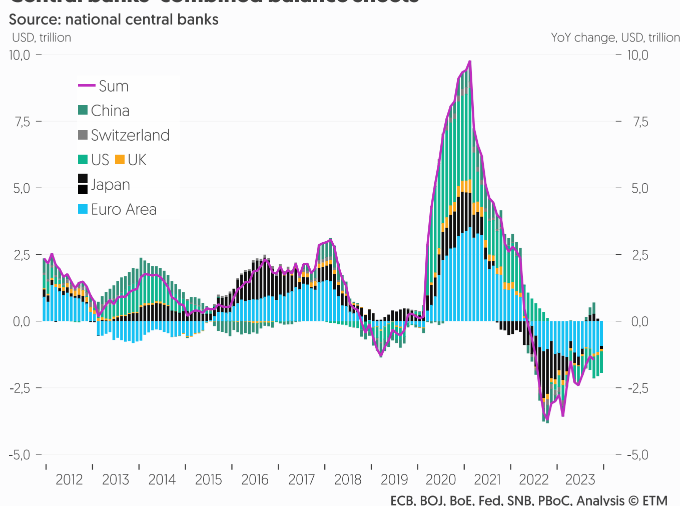


In its latest FOMC decision, the Fed left rates unchanged in line with expectations. What was not expected was the tilt towards a more dovish outlook for interest rrates in 2024. In its statement, Fed Chairman Jerome Powell confirmed that members of the FOMC were no longer projecting any need for rate cuts, that the base case is not for cuts and that 17 of the 19 members polled saw interest rates lower by the end of 2024.

This was a significant departure from the Fed's more hawkish and conservative position in recent months and ensured that the market was given the green light to actively price in rate cuts. And price in rate cuts they did. Whereas before the FOMC meeting, the market was positioned for three 25bp rate cuts in the US, that has shifted to favour as many as five.

Focus has now shifted to the other central banks, but they too will have a tough time trying to convince markets that the inflation picture still warrants a conservative monetary policy stance. On the contrary, the communication from most central banks is that inflation is coming down, and that they will look at turning more sensitive to the longer-term growth prospects that have steadily deteriorated, the longer the central banks have kept interest rates well elevated,

However, central banks are still tightening

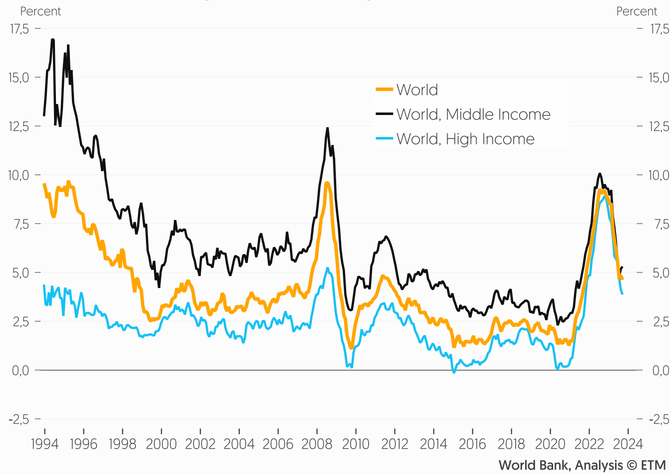


While much emphasis is placed on interest rate policy, it is worth pointing out that the major central banks are still tightening monetary policy and actively withdrawing liquidity from the global economy. The amount of quantitative tightening is clearly evident in the accompanying chart, which shows the pace of balance sheet contraction.

Although the contraction is still dwarfed by the amount of quantitative easing that was originally injected into the economy, it represents a secondary form of tightening that is not as visible to ordinary households or most market professionals. However, it actively constrains monetary growth and further removes the amount of monetary space available for inflation to take hold.

However, the combination of smaller balance sheets and higher interest rates is already affecting inflation.

.Inflationary pressures firmly subsiding

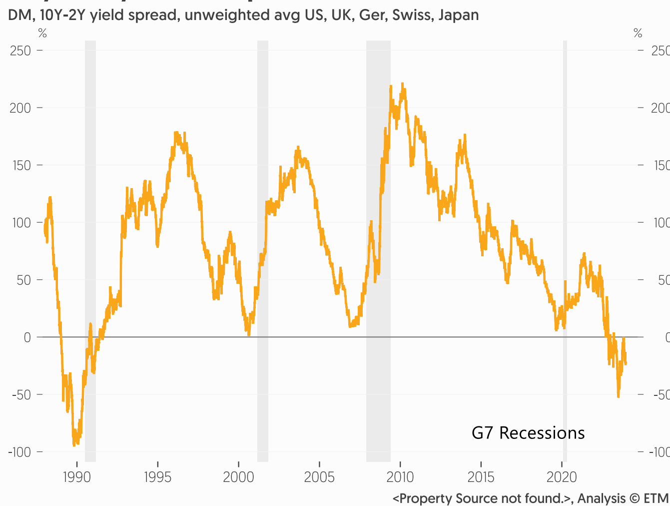


Inflation is well off its highs and trending firmly lower. Not only has the peak in inflation passed, but there is momentum behind the moderation in price growth. Analysis of inflation trends worldwide confirms this and suggests that the central banks have done enough to contain price pressures, especially if they continue shrinking the size of their respective bank balance sheets.

So long as these inflationary pressures continue subsiding, the central banks will be hard-pressed to persist with their hawkish rhetoric. Through the months ahead, they are likely to turn their focus towards a transition towards more growth-sensitive policies and the achievement of a soft landing.

This drop in inflation will also help generate a more predictable GDP growth environment that will help stabilise overall financial market conditions and help reduce overall risk assessments.

Leading indicators still pointing to weak growth

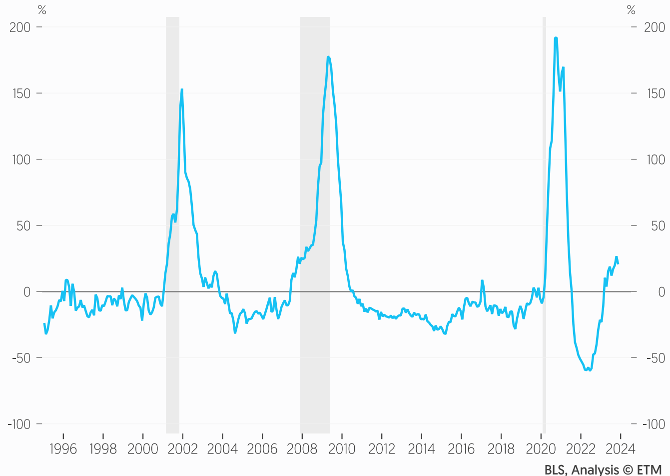


Turning more sensitive to the business cycle is justified and arguably overdue. The shape of the yield curve has traditionally been one of the best leading indicators of the business cycle, and when it inverts, it portends some difficult economic times ahead with a lead of between 15-18 months.

The recessionary conditions are typically set in motion when the central banks start to reduce interest rates, which has historically resulted in a steepening of the yield curve. The accompanying chart shows that the curve has disinverted more recently, which confirms that the recessionary conditions are fast approaching.

Typically, central banks will only reduce interest rates when faced with moderating inflation or deteriorating growth prospects, which they will want to mitigate. Currently, it is a combination of both.

US labour market losing its resilience quickly



Whenever the US labour market has suffered substantial growth in permanent job losses, it coincides with recessionary conditions. This important indicator is once again in danger territory and flagging a deterioration in the substance of the labour market.

It suggests that the labour market is no longer as resilient and holds the potential to deteriorate quickly should the momentum behind job losses intensify.

This reliable indicator has picked periods of recession in the past three decades and is one we continue to take seriously. It confirms that the world's most influential economy is about to enter a phase that may compound the difficulties in the Asian economies that are also struggling for traction. It implies that the global economy is about to experience difficulties that will prompt central banks to become more growth-sensitive.

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