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https://blog.en.erste-am.com/rapid-and-synchronous-key-rate-hikes/

Rapid and synchronous key rate hikes

Gerhard Winzer

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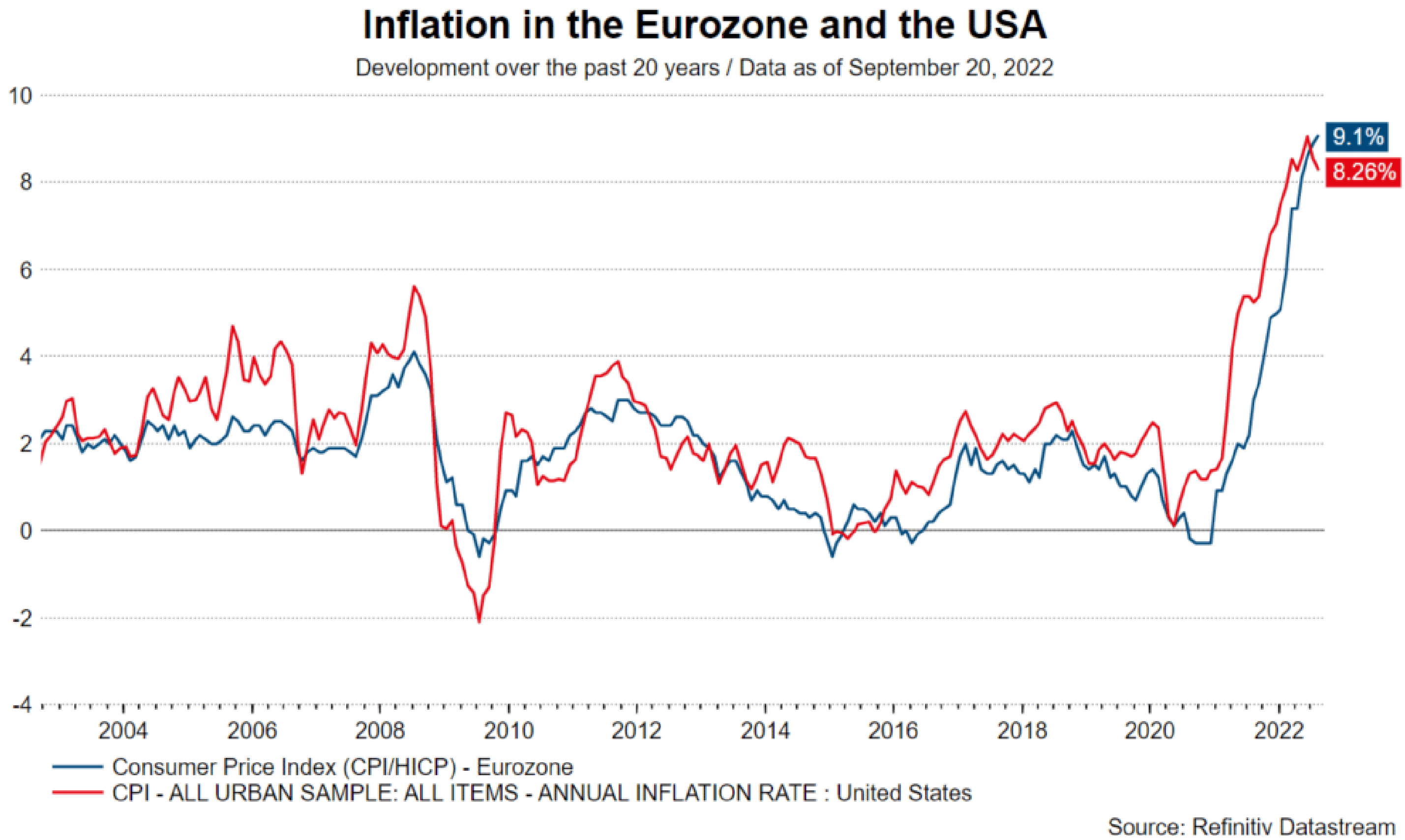
The main driving factor for markets since the beginning of the year has been the sharp increase in key rate hike expectations for advanced economies as inflation has remained unexpectedly high. This is putting downward pressure on asset prices in two ways. First, the higher the discount rate, the more the present value falls. Second, the rapid and synchronous key rate hikes by central banks pose downside risks (recession) for the global economy.

Falling inflation outside Europe

At least at a global level, there are signs of a fall in inflation in the second half of the year compared with the first six months. In the USA, consumer price inflation rose only slightly in July (0% month-on-month) and August (0.1% month-on-month). The main reason for this is the fall in energy prices. In Europe, however, this trend is not discernible. In the euro zone, consumer price inflation climbed by 0.6% month-on-month in August to 9.1% year-on-year.



Source: Refinitiv Datastream, data as of Sept. 20, 2022; Note: Past developments do not allow reliable conclusions to be drawn about future developments.

Core inflation too high

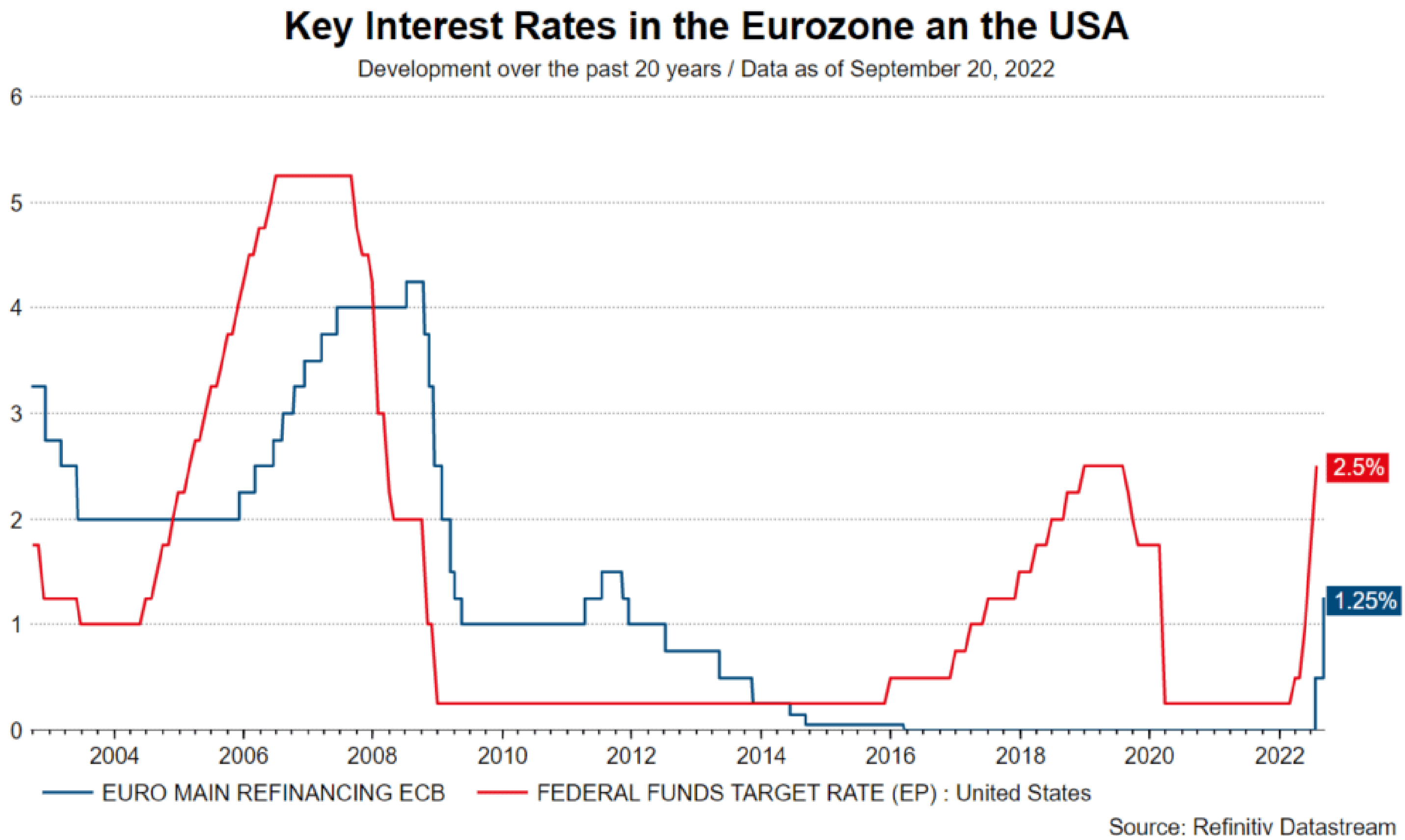
However, looking at headline inflation masks a key, troubling development. Even in the countries with declining inflation, pass-through effects from the original inflation drivers (energy, goods prices) to numerous other price components have set in. In the USA, consumer price inflation excluding food and energy (core rate) rose much more strongly than expected in August (by 0.6% month-on-month to 6.3% year-on-year). In the UK, core inflation rose by 0.8% p.m. to 6.3% p.a. and in Sweden by 0.6% p.m. to 6.8% p.a.

Increasing expectations for key rate hikes

In line with this, expectations for quick rate hikes have increased in numerous countries over the past week. The priced-in Fed funds rate for March 2023 has risen to 4.4% from 4.0% on Monday. There is a growing realization that the monetary policy stance has been far too expansionary and that restrictive interest rates are needed to contain underlying inflationary pressures. However, there is considerable uncertainty about the dynamics of inflation. Underlying inflation, and hence the real interest rate, cannot be estimated with satisfactory accuracy. As a result, central banks also have little idea about the interest rate level at which monetary policy actually starts to have a restrictive effect.

Fed key rate hike by 75 basis points

In the coming days, at least one central bank is expected to raise its key interest rate by 0.75 percentage points. For the U.S. central bank, the increase from 2.5% to 3.25% is already reflected by market prices. But the central banks in the United Kingdom (Bank of England) and Sweden could also raise the key interest rate substantially (BoE: from 1.75% to 2.5%, Riksbank: from 0.75% to 1.50%). The European Central Bank (ECB) also made a significant interest rate hike of 75 basis points at its last meeting.



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Falling economic indicators

In addition to persistently high inflation, high-frequency survey-based economic indicators point to a slowdown in global real economic growth. Next Friday, the Purchasing Managers' Index (PMI) flash estimates for the month of September will be released for major countries in the developed economies. In August, the manufacturing PMI pointed to a recession in the manufacturing sector. Even if the overall PMI were to rise in September, the interpretation would likely not be favorable. After all, if a recession does not materialize immediately, the scope or even the need for central banks to raise key interest rates even more increases.

Glimmers of hope

Of course, there are also glimmers of hope. In the USA, the University of Michigan's preliminary consumer sentiment report for September showed inflation expectations falling further. One-year inflation expectations are now well off the March high (4,6% vs. 5.4%). At 2.8%, long-term inflation expectations are also below the recent high (3.1% in June). The Fed will also have noticed this development. Market speculation for an interest rate hike by a full percentage point next Wednesday is exaggerated.

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He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.