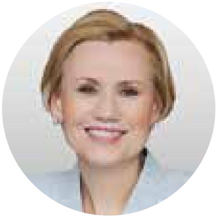
Central banks meet in June, but when will rate cuts begin?

Weekly Market Compass | May 29, 2024



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European Central Bank

Europe seems extremely likely to cut rates in June, in my view, as progress on inflation has been significant.

Bank of Canada

Inflation has slowed, and I give the Bank of Canada a 50/50 chance of a rate cut at its June meeting.

US Federal Reserve

The Federal Reserve seems poised to sit on its hands in June as members have said they need more data to cut.

When I was a child, springtime was full of excitement. We all knew that warmer weather and summer break were just around the corner, but we didn't know exactly when they would arrive (depending on the number of snow days we had taken, the last day of school could vary by a few days). Still, the anticipation we all shared was universally positive. And this spring, I believe markets are in a similar anticipatory period, waiting for different central banks to begin cutting interest rates. We expect it to happen soon, even if the exact timing is less certain, and the wait has been generally positive, with major stock indices around the world hitting record highs in the last several weeks.

So where do we stand as May comes to a close? Here's what I expect to see during central bank meetings in June.

Bank of Canada: June 5

Last week we got a reading on Canadian inflation that showed significant progress, as the Consumer Price Index (CPI) rose 0.5% month-over-month and 2.7% year-over-year in April.[1] This was in line with expectations and is the slowest pace in three years.

More importantly, core CPI, which excludes food and energy prices, rose 0.1% month-over-month for a fourth consecutive month, suggesting inflation is well under control.[1] The Bank of Canada is focused on core inflation, as explained in its April monetary policy decision announcement: "The Governing Council is particularly watching the evolution of core inflation, and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth and corporate pricing behaviour."[2]

This is the last CPI reading before the Bank of Canada meets in June - and I believe it has significantly increased the odds of a June rate cut. On the other hand, the Bank of Canada may be reluctant to move just yet given the possibility, as articulated in the Federal Open Market Committee minutes and from some US Federal Reserve (Fed) speakers, that the Fed could hike rates. This would be problematic for Canada's currency, causing a depreciation versus the US dollar. I give a 50/50 chance of a cut at this Bank of Canada meeting.

European Central Bank: June 6

The ECB seems extremely likely to cut rates at its June meeting, in my view. Progress on inflation has been significant. The April eurozone inflation report showed headline CPI at 2.4% and core CPI at 2.2% year-over-year. Services CPI is still hot but has slowed significantly, down to 3.7% year-over-year.[3]

Also encouraging is the decline in consumer inflation expectations in April, which was just released. Inflation for one year ahead is expected to be 2.9%, which is the lowest level since September of 2021. And expectations for three years ahead moved from 2.5% to 2.4%.[4] Now, we did see a reacceleration in hourly labor costs, but I think that is very unlikely to stop the ECB from cutting in June.

US Federal Reserve: June 12

The Fed seems certain to sit on its hands at this meeting. On the bright side, April CPI data showed a resumption of disinflationary progress after some stalling in the first quarter. In addition, the final reading of University of Michigan consumer inflation expectations for May was lower than expected, indicating inflation expectations are well anchored. However, it's clear that is not enough to satisfy the Fed.

A number of Fed speakers in the last several weeks have communicated that they need more data to be confident about starting to cut rates. I think Fed Governor Chris Waller summarized the views of the majority of Federal Open Market Committee (FOMC) participants in his comments last week: "In the absence of a significant weakening in the labor market, I need to see several more months of good inflation data before I would be comfortable supporting an easing in the stance of monetary policy."[5] This comes on the heels of the release of the May FOMC meeting minutes which were more hawkish than expected, with some participants indicating a willingness to hike rates if need.

The Fed's preferred gauge of inflation - the Personal Consumption Expenditures Price Index - will be released at the end of this week. It will obviously be closely watched and has the power to move markets. But it alone will not be enough to move the Fed. Having said that, I still believe a rate cut in the third quarter is still very likely.

It is worth noting that Asian central banks will likely wait for the Fed to begin cutting because of the need to protect their local currencies in the face of a strong US dollar.

Bank of Japan: June 17

The Bank of Japan (BOJ) appears to be achieving its goal of sustainably reaching 2% inflation after decades of being under that target. Japan's inflation rate for April was 2.5% year-over-year, and its core CPI, which excludes fresh food but includes fuel costs, rose 2.2% year-over-year; this represented a second month of moderation in inflation but is still above the central bank's target.[6] What's more, consumer inflation expectations have recently increased, making it easier for the BOJ to hike again.

The BOJ seems to have another objective as well - helping to strengthen the Japanese yen in the face of downward pressures. BOJ Governor Kazuo Ueda has expressed confidence in the Japanese economy: "I continue to believe that the Japanese economy will pick up, even with the data released after the BOJ's policy meeting in April."[7] Not surprisingly, in recent weeks the BOJ has been sounding more hawkish. While it is not expected to hike rates in June, the probability has increased of more than one rate hike before the end of 2024. This has impacted the Japanese government bond (JGB) market where the 10-year JGB yield exceeded 1% for the first time in 11 years.[8]

Reserve Bank of Australia: June 18

Inflation has been more stubborn in Australia, so much so that there have been concerns the Reserve Bank of Australia (RBA) might hike rates this year. I do not believe that will happen, although I expect the RBA to be one of the late movers when it comes to rate cuts.

Bank of England: June 20

The April inflation report for the UK showed significant progress on inflation - but less than expected. Particularly disappointing was the very modest progress made in terms of services inflation. A cut at the June meeting is clearly off the table, in my view, although some progress on services disinflation should be enough for the Bank of England to cut in August.

Global central banks are largely headed to the same destination

Because of these anticipated policy differences in the near term, a robust carry trade has emerged, with investors borrowing money in low interest rate currencies and using it to invest in currencies with rates expected to remain higher for longer. I anticipate that will continue in the shorter term given that the start of rate cuts will clearly be staggered among early movers and late movers. However, I expect all these central banks will begin rate cuts in 2024, just like all schoolchildren eventually get to summer vacation. And I anticipate most if not all these central banks to be on a path of gentle easing (or gentle tightening, in the case of the Bank of Japan) which will likely result in a supportive environment for risk assets.

Notes

[1]Source: Statistics Canada
[2]Source: Bank of Canada press release, April 10, 2024
[3]Source: Eurostat
[4]Source: European Central Bank, May 28, 2024
[5]Source: Reuters, "Fed officials urge patience on timing of initial rate cut," May 21, 2024
[6]Source: Japan's Ministry of Internal Affairs and Communications
[7]Source: Bank of Japan
[8]Source: Bloomberg, as of May 24, 2024

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

The Consumer Price Index (CPI) measures change in consumer prices.

Core inflation excludes food and energy prices, while headline inflation includes them.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.