

On the 'disinflation train': Is this the end of the line for rate hikes?



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Disinflation trend

Recent data reports from the US, Europe, and Canada show that inflation has been slowing.

Central banks

The Federal Reserve, the Bank of Canada, the Bank of England, and the European Central Bank have all kept rates steady in their most recent meetings.

Market response

It appears markets are finally getting the memo that central banks are very likely done hiking rates.

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In New York City, one of the best-known subway lines is the D Train, an express line that runs from the Bronx to Manhattan to Brooklyn. But in my lexicon, there is another 'D' Train. In fact, for a while now, I've been answering questions about inflation by saying "We're on the D Train." Why? I believe developed economies are on the disinflation train, which is providing express transportation to the end of the rate hike cycle — and ultimately the start of rate cuts.

I've also said that not every data point would perfectly support the disinflation narrative, but if we look at all the data as a whole, we would see Western developed economies are cooling and there is a strong disinflationary trend underway. I think this is coming to fruition. Just consider the data we have seen recently.

Europe, Canada, and the US appear to be experiencing disinflation

- The eurozone composite Purchasing Managers' Index (PMI) for October clocked in at 46.5, which is down from 47.2 in September, suggesting the economy weakened further at the start of the fourth quarter after contracting in the third quarter.¹ The press release noted that this "in part reflected a cooling of a post-pandemic surge in spending on travel and recreation."¹
- The flash estimate of eurozone inflation for October fell to 2.9% year-over-year from 4.3% in September and 10.6% in October 2022.² Core inflation is still estimated to grow at a 4.2% pace, down from September's core rate of 4.5% and well below its level a year earlier.²
- The Canada jobs report supported the view that the Canadian economy is also cooling. Canada added a net 17,500 jobs in October, which was below expectations, and the unemployment rate climbed from 5.5% to 5.7%, which was higher than expected.³ Average hourly earnings were 5.0% year-over-year in October, down materially from 5.3% in September.³
- The headline inflation rate in Canada declined to 3.8% year-over-year in September from 4% in August; this was below market expectations of 4%.⁴ And core inflation is at 2.8% year-over-year, down from 3.3% the previous month.⁴
- The US jobs report showed a lower level of job creation at 150,000 for October; in addition, September nonfarm payrolls were revised downward.⁵ Labor force participation remained relatively stable. Unemployment rose slightly to 3.9%.⁵ Most importantly, in my opinion, average hourly earnings fell to 4.1% year-over-year for October from 4.3% in September.⁵
- The Institute for Supply Management (ISM) Manufacturing PMI for the US was 46.7 for October, well below expectations of 49.0.⁶ In addition, the ISM Services PMI was 51.8, down from 53.6 in September.⁶

Central banks recognize the disinflation trend

As a result of this disinflation trend, the Federal Open Market Committee (FOMC) kept US interest rates steady at its November meeting — a dovish pause. US Federal Reserve (Fed) Chair Jay Powell certainly reserved the right to hike rates again, but my view continues to be that the Fed is very likely done with rate hikes. Key points⁷:

- Powell was positive about the moderation in wage growth: "...wage increases have really come down significantly over the course of the last 18 months to a level where they're substantially closer to that level that would be consistent with 2 percent inflation over time." This adds to the case for a continued pause in December that, in the rearview mirror, turns into the end of rate hikes.
- On the topic of a high 10-year US Treasury yield helping to tighten financial conditions and serve as a substitution for more rate hikes, Powell said he wants to see persistent changes in financial conditions that are material. He said he wants to see higher longer-term rates not connected to expectations of higher fed funds rates — although he acknowledged that currently seems to be the case. He also said he believes US mortgage rates at current levels could have a rather significant impact on housing. However, he tried to leave the door slightly open to more rate hikes by saying that he's not sure financial conditions are restrictive enough to finish the fight against inflation. (Although I believe he is just saying that to try to keep a lid on financial conditions and prevent them from rising prematurely.)
- Powell noted it takes time for the effects of monetary policy to show up in the economy, so the Fed slowed its rate hikes this year to give it time to assess. This suggests a "prolonged pause" going forward (which would, in the rearview mirror, represent the end of the rate hike cycle).
- Powell was rather dismissive of the Fed's September "dot plot" which showed a possible rate hike in December and only two implied rate cuts for 2024, saying that "the efficacy of the dot plot decays over three months" and that it's "not a promise or plan of the future."
- Powell made it clear that he is wedded to continuing quantitative tightening at its current pace. Something has to give since he has said he wants to proceed cautiously — so that also suggests to me foregoing any more rate hikes.

The Bank of England (BOE) also decided to keep rates steady at its last meeting. The BOE's Monetary Policy Committee (MPC) voted to keep its policy rate on hold at 5.25%, recognizing that the risks of overtightening policy are increasing. This follows both the European Central Bank and the Bank of Canada's decisions last week to keep policy rates static.

As Bank of England member Swati Dhingra recently noted, there are long lags between monetary policy decisions and their impact on the economy. She suggested that the UK economy currently only reflects a small portion of all the BOE hikes in this cycle. As I have said, the lagged effects of monetary policy should be an important consideration for central bankers; it is the prism through which they should view the economy and inflation and consider next steps. And I believe more are starting to do just that.

Markets have started to absorb what central banks are saying

Markets are finally getting the memo that central banks could very likely be done hiking rates. The 10-year US Treasury yield eased significantly the week ending Nov. 3, starting with the underwhelming ISM Manufacturing

PMI, then the dovish Fed meeting, and then the tepid jobs report.⁸ Other long bond yields also followed this trend, from 10-year UK gilt yields to 10-year German bund yields.⁹

What does that mean? It means that it is highly unlikely we see any more rate hikes from Western developed central banks. And we could see rate cuts coming soon; I believe central bankers “doth protest too much.” Yes, they would like to keep rates higher for longer, but if the cumulative effects of rate hikes already enacted will soon have far more of an impact on inflation and growth, that may mean they must start cutting sooner — and that likely could start with the Bank of England.

What we know is that in recent tightening cycles, the Fed has started to cut rates within eight months of their last rate hike. With the Fed’s last rate hike in July, that suggests a cut could happen in the second quarter.

Could oil prices slow the disinflation train?

Yes, there are risks to the view that disinflation will continue — specifically higher crude oil prices. However, as I have noted before, higher oil prices have taken time to seep into core inflation. In the meantime, they can reduce spending power and, thereby, tamp down consumer demand, helping do some of the Fed’s work for it. And luckily, we have actually seen oil prices in retreat in recent days.

Conclusion

Looking ahead, I anticipate volatility because there is still significant monetary policy uncertainty (and other geopolitical uncertainties). That means we could still see yields trade in a wide range, and we could see a ‘good macro news is bad market news’ scenario play out in the near term. But risk appetite is edging up as each day likely brings us closer to the definitive end of rate hikes (and, arguably soon thereafter, the start of rate cuts...).

Dates to watch

Date	Report	What it tells us
Nov. 6	Bank of Japan Monetary Policy Meeting Minutes	Gives further insight into the central bank’s decision-making process.
Nov. 7	Reserve Bank of Australia Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
Nov. 7	UK GDP	Measures a region’s economic activity.
Nov. 7	UK Industrial Production	Indicates the economic health of the industrial sector.
Nov. 10	Michigan Inflation Expectations (preliminary)	Tracks consumer sentiment regarding inflation.
Ongoing	Several speeches from Fed Chair Powell and other FOMC members	Gives further insight into the views of Federal Reserve members.

Notes

¹Source: S&P Global/Hamburg Commercial Bank, as of Nov. 6, 2023

²Source: Eurostat, as of Oct. 31, 2023

³Source: Statistics Canada, as of Nov. 3, 2023

⁴Source: Statistics Canada, as of Oct. 17, 2023

⁵Source: US Bureau of Labor Statistics, Nov. 3, 2023

⁶Source: Institute for Supply Management, as of Nov. 3, 2023

⁷Source: Transcript of Fed Chair Powell's Press Conference, Nov. 1, 2023

⁸Source: Bloomberg, Nov. 3, 2023

⁹Source: Bloomberg, Nov. 3, 2023

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

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

Inflation is the rate at which the general price level for goods and services is increasing.

Core inflation is the change in the costs of goods and services, but it does not include those from the food and energy sectors.

Headline inflation is the total inflation in an economy, including food and energy.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

A basis point is one hundredth of a percentage point.

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 Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

Dovish refers to an economic outlook which generally supports low interest rates as a means of encouraging growth within the economy.

The policy rate is the rate that is used by central bank to implement or signal its monetary policy stance.

The European Central Bank (ECB) is responsible for the monetary policy of the European Union.

The eurozone (also known as the euro area or euroland) is an economic and monetary union of European Union member states that have adopted the euro as their common currency.

Quantitative tightening (QT) is a monetary policy used by central banks to normalize balance sheets.

ISM Purchasing Managers' Indexes (PMI) are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

GDP (Gross domestic product) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

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

Tightening monetary policy includes actions by a central bank to curb inflation.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

The opinions referenced above are those of the author as of November 6, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.