23rd January 2024

Market Update – The Timing of Interest Rate Cuts and the Ups and Downs along the Way

Central Bank Objectives

In many ways, the role of central banks has been simple over the last two years: inflation has been above target and so interest rate hikes were needed. Now it is a more conflicted role: inflation is well on the way towards the 2% target, yet crucially there are hard yards still to go. The path ahead now seems to have three possible routes:

a. Find the sweet spot for rates and inflation will be brought under control with only moderate economic slowing;
b. keep rates too high and reduce inflation but create a recession;
c. cut rates too soon and risk a resurgence in inflation.

Swinging Sentiment

Every monetary policy official is aiming for scenario a. and markets currently believe there is a good chance that this will be achieved. Yet, b. and c. cannot be ruled out and so careful judgement is now required by those in charge and market sentiment will likely swing as investors assess the chances of achieving scenario a.

Judging the Pivot

It now appears almost a certainty that the next move in interest rates will be a cut, rather than any further hikes, but with figures released last week showing the inflation rate increasing again in the US, Europe and the UK, the difficulty in judging when to pivot on interest rates is clear.

UK Inflation Rises

UK CPI rose from 3.9% to 4.0% in the 12 months to December 2023. Economists, on average, had expected a drop to 3.8%. While this is an unwelcome development, and one created by higher prices for alcohol and tobacco, it is not expected to change the broader trend of slowing inflation. A falling inflation rate is expected to resume in the coming months, with a likely large drop in the Ofgem energy price cap in April to have a big effect on the official inflation measure. What's more, the labour market, which has been fuelling inflation with its tightness, is showing further signs of loosening with wage growth continuing to fall from its mid-2023 peak. Should this continue, this would remove a major stumbling block in the battle to get both headline and core inflation measures back to more normal levels.

Hope/Despair

To summarise the current inflationary position, then. Inflation has fallen heavily from its peak, but remains significantly above target. The latest data shows that there will be challenges as central banks continue to aim for 2%, but broad expectations are that this will be achieved. Investors therefore believe this is the path we are on, but inconsistent markets show that hope and despair are never too far apart.

Santa Rally

From late October to the end of 2023, the signs were positive that multiple cuts were likely. Inflation figures were coming in below expectations and central banks' announcements no longer included serious threats to further raise interest rates. As a result, markets rallied strongly and we experienced a 'Santa Rally' in December.

A Sober Assessment

In 2024 so far, a more sober assessment has been in place by investors in general. More work is yet to be done in order for inflation to come down, with the surprise jump in inflation data evidence of this. As such, we have seen both equity and bond markets fall in value during the first few weeks of the year.

Slowing Inflation

Moving forward from here, there is likely to be continued volatility, but should inflation resume its slowdown then optimism is likely to resume, as interest rate cuts will be expected.

When to Cut

In the US, markets are predicting March as the time for the first interest rate cut, while May is seen as the likely timing for the UK. The higher inflation figures of last week have reduced confidence in these timings, with slightly later dates increasingly likely. Any further inflation spikes would push out expectations further still, at the margin, but spring and early summer look likely to be when central banks will act. Investors will be waiting eagerly.

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