Macro Outlook Summary

January 2024

Over coming quarters we see the storylines for the ECB and the Federal Reserve diverging. While the Fed has blue water ahead given inflation is nearly back in range, the ECB is not quite there. Their ongoing focus is on wanting hard evidence of an easing in wage settlements and a redress in the job vacancies versus unemployment imbalance.

While conditions are easing, tight labour markets in Europe have not eased to the same degree as in the US. Hence President Lagarde remains insistent that the committee needs more data points on EU wage growth before calling the all clear. The nuance here is that the data is quarterly not monthly and we still wait for the 4Q23 reading. Lagarde is effectively saying she wants to see that reading and the 1Q24 which should be released early May and if both readings show an easing of pressure then the committee can cut rates, but only then.

This indeed makes sense because EU wage growth at 5.3% is at its peak and its across pretty well all sectors so its systemic. Any cut earlier would be seen as reacting to weak GDP data rather than fighting inflation and could seriously undermine ECB credibility. There is no doubt the ECB needs to help economic activity in Europe but only after the threat of inflation has been removed.

The US on the other hand is in a far better place. Despite hiking rates further than the EU, the US economy remains strong. Taking a step back from obsessing over rate cutting, the obvious question is if the economy is doing so well then why is any rate cut necessary? The Fed of course is looking forward to estimate the future size and impact of real rates when inflation has returned to 2%, thinking that positive real rates are generally understood to represent a tightening of financial conditions.

Recently Chair Powell talked about exactly this and how they gauge the true tightness of 'US financial conditions'. They have several measures and the market has many more, but what seems abundantly clear is that while the economy is growing satisfactorily there is no case for Fed Funds to be cut below 2-3% and the ultra low interest rate world we used to live in has gone. Given Fed Funds rates are currently 5.25% there is plenty of scope for the Fed to cut later this year which means the outlook for rates and bonds is extremely favourable.