Macro Outlook Summary

September / October 2023

As we discussed last month the 'higher for longer' outlook for interest rates has now taken centre stage. Over the past two months the longer end of every government bond market has adjusted to this view and removed the yield curve inversion prevalent earlier this year. Current government bond yields and pricing makes far more sense while talk of a US recession has fizzled out and the consensus holds for a US soft landing as the central outcome. This will be a good outcome for the US economy with inflation close to target.

Markets appear to be thinking that US monetary policy has done its job and the prospect of the Fed cutting rates to rescue a failing economy will not be required and is therefore not on the cards. Hence the dollar's strength with rates likely to stay where they are even as the economy continues to grow. In addition higher rates support the government's ability to finance their large borrowing requirement.

Other major G10 economies are not so well placed as they contend with sticky inflation, resurgent inflation or second order inflation while at the same time their economies weaken. The FX market has been pricing up this fundamental divergence in outlook by strengthening the USD.

So for example in the UK and Europe it seems all too likely that the BoE and the ECB will hesitate in their fight against inflation when economic weakness takes hold. Rhetoric about fighting inflation will remain but rate hiking actions will be muted as they adopt a 'wait and see' approach pointing to the supposedly substantial rate hikes already in place.

If inflation goes sideways or just edges down marginally (and long before it reaches 2%) while significant economic weakness takes hold then both central banks seem likely to throw an economic lifeline with rate cuts. The suspicion is that their modelling says economic weakness will rapidly dissipate inflationary pressures and for their public standing the economy matters more than inflation.

As numerous global tensions keep promoting inflationary forces while GDP weakens, the inevitability of numerous central banks facing this dilemma seems all too real.

For 15 years since the GFC we have lived in a cosseted world where any economic stress has been soothed by central banks delivering rate cuts and liquidity injections. They had this luxury because inflation was non-existent. If inflation refuses to fall back below 2% can central banks really continue to behave as before in managing economic weakness with rate cuts and still not completely undermine investor confidence?