CENTRAL BANK WATCHER

Ain't no mountain high enough

ROBECO
The Investment Engineers

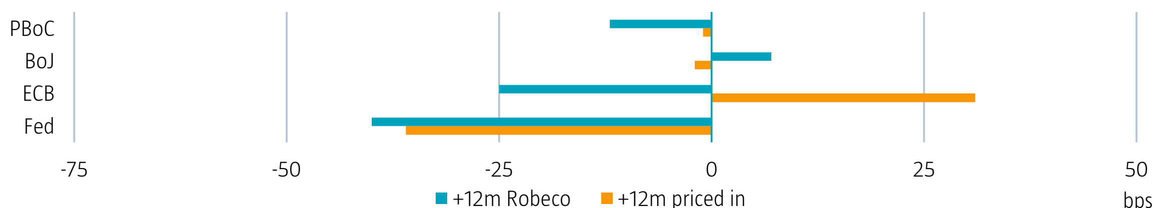
- Fed: final stage extended
- ECB: insurance has a price
- PBoC: change of heart
- BoJ: policy trilemma

There's no mountain high enough to bring inflation back under control. That's the message from many of the main DM central banks, including the Fed and ECB. That message has been deemed credible if judged by the relative stability of the market's medium to long-term inflation expectations. But it also comes at a cost.

By continuing to hike rates further into restrictive territory in an environment where overall inflation has already started to come down meaningfully, they deliberately run the risk of overtightening. This is seen as a risk worth taking, because rate hikes are more easily reversed than long-term inflation expectations. We expect the BoJ to join the camp of central banks' tightening policy, but only slowly. This corresponds with the gradual pace with which Japanese inflation and wage data have been rising as of late.

While we see hiking cycles for many DM central banks being extended till the end of Q3, the PBoC is in an entirely different situation. Chinese growth is stagnating, despite the post-Covid reopening and policymakers having been easing conditions to stimulate the economy. Ain't no mountain high enough indeed has a different meaning for individual central banks.

Outlook for central bank policy rates



Source: Bloomberg, Robeco, change 12m ahead, based on money market futures and forwards; 3 July 2023

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Marketing material for professional investors, not for onward distribution

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The Federal Reserve: final stage extended

- Sentiment around regional banking stress has calmed
- Fed signaling two more rate hikes this year
- Our base case is for these to be delivered

Extended tightening cycle

Sentiment around Fed policy has moved rapidly. The impact of the regional banking stress has been more contained than previously feared and the Fed tightening cycle will most likely be extended. That much is clear from recent comments and projections of the FOMC members. In their June meeting most FOMC members forecasted hiking the Fed funds rate by another 50 bps, to 5.6%, this year. While these forecasts typically are revised, we think additional tightening will be delivered.
After a temporary pause, or skip, in June, a 25 bps hike in the 25-26 July meeting is our base case. As mentioned, FOMC members have become less worried about possible economic consequences from the regional banking crisis, while high growth in jobs and wages have left them concerned about the progress made in bringing inflation back to target. The FOMC looks keen to cement their inflation-fighting credentials. Probably even weaker jobs and inflation data will not hold them back from lifting rates in July.

We expect inflation to come down further in the coming quarters, forecasting close to 3.5% headline and core CPI by year end. Whether this decline will be quick and credible enough for the Fed not to hike in September remains uncertain. Our estimates suggest that most of the moderation in inflation will come from rents. If materialized this will be welcomed by the Fed, but their main focus is now on inflation from services ex-rents. In this category we also forecast a decrease, but the number of data points to prove any such trend is limited before the 19-20 September meeting. In case of doubt, the FOMC will probably opt to hike rates, being keen to avoid the impression of being too relaxed on inflation. Our base case is therefore for hikes in both July and September. At minimum we should expect hawkish Fed rhetoric to continue over the summer. This will also be seen as helping to prevent an unwarranted loosening of broader financial conditions.

The extension of the tightening cycle has an important impact on front-end rates. This stems not so much from the amount of additional hikes priced in, which is relatively modest, but more from pushing out the timing of expected rate cuts. Even skipping a hike in September, but expressing the intention to hike again in November could have this effect.

What is priced in for the Fed, versus our expectation

Fed funds rate (% upper	5.25	Sep/23	Dec/23	Mar/24	Jun/24
Change implied by FF Futures (bps)		29	16	-3	-36
Our probably-weighted expectation (bps)		40	35	19	-40
Our central scenario (bps)		50	50	25	-25
Fed funds rate central scenario (% upper bound)		5.75	5.75	5.50	5.00

Source: Bloomberg, Robeco; 30 June 2023

The market is currently pricing in an 80% chance of a 25 bps hike in July and approx. 50% chance of a similar step before year-end. Shorter term we therefore see further upside risk to short-end rates.
We don't expect any changes to the Quantitive Tightening (QT) policy in the coming months. The T-bill issuance to replenish the general account of the Treasury (TGA) has not had a large impact on reserves at federal banks. These are still approx. USD 700 bln, or seven months of QT, above what is regarded as an evaluation level for the Fed (USD 2.5 tln), suggesting that from this perspective QT can continue till early 2024.

Risk of overtightening growing

So far growth has been holding up remarkably well. Supported by a strong labor market, high consumer spending growth has been able to counterbalance weakness in capex and inventories. Still, with the Fed likely to hike further, we see the risk of overtightening increasing. Rates are in restrictive territory – we see neutral at 2.5-3.0% – and every additional hike from here should have further negative implications for growth. Signs of such implications have been occurring. The SVB failure and regional banking stress are examples, but also the start of an uptrend in bankruptcies. With the Fed

expressing their anti-inflation stance and growth likely feeling increased pressure from tighter monetary policy, we would expect rates from the belly on to move into more stable territory. As the risk of overtightening grows, so does the risk that extra hikes now will be followed by rate cuts later.

USTs	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	4.92	4.06	233	135
5yr	4.18	3.78	78	37
10yr	3.88	3.75	43	21
30yr	3.92	3.82	20	10

* for a 1pd position over 12 months

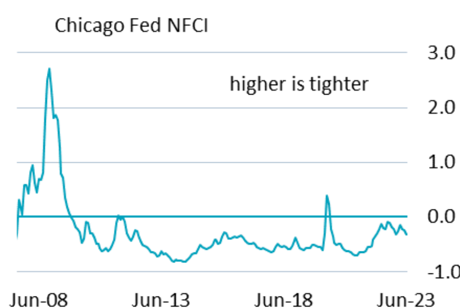
Source: Bloomberg, Robeco; 30 June 2023

Rates market conditions

The pricing out of expected rate cuts has been the main driver of US rates markets recently. The expected Fed funds rate for December 2024 has risen from a low of 2.7% in early May to 4.2% in early July. From this move one can conclude that much of the flight to safety related to the regional banking stress has been priced out. But what are realistic assumptions on how much further this move can go? The spread between December 2023 and December 2024 is now priced at -1.3% and has been in a range of -1.0 to -1.7% since December. If we assume this range holds and cuts get priced out further, while two hikes will be fully priced in, this suggests approx. 30-40 bps upside risk to front-end rates. Assuming the current beta (of 1.5) between front-end and 10-year rates holds, this suggests approx. 25 bps upside risk to 10-year yields. Given our view of cooling inflation and growth we would expect risk-reward to be more attractive while approaching those levels. The same analysis suggests some further potential for yield curve inversion shorter term. We have reduced the size of the 2-10 steepener on the US curve in March. For adding to steepeners we are now also watching alternatives such as 5-10 or 5-30, which have significantly corrected as well.

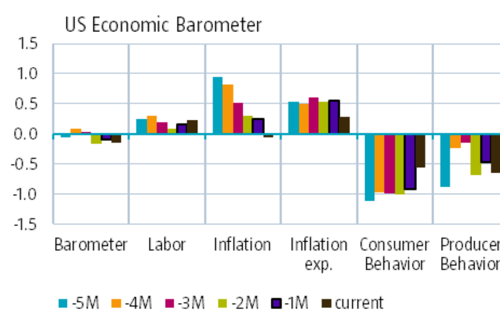
The US economic barometer signals a slowing of inflation pressures. Financial conditions have tightened modestly.

Chart 1. Stable financial conditions



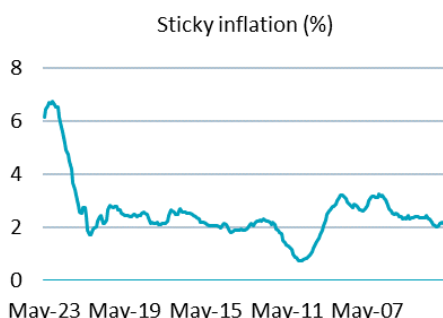
Source: Robeco, Bloomberg; 30 June 2023

Chart 2 Barometer signals lower inflation



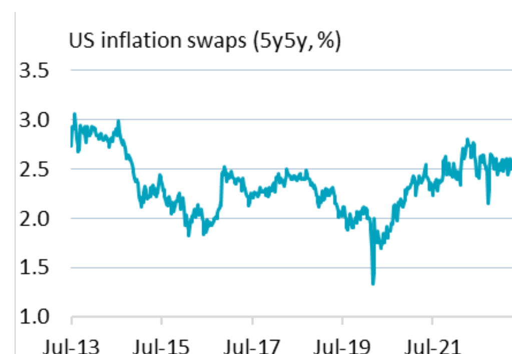
Source: Robeco, Bloomberg; 30 June 2023

Chart 3. Slow moving inflation turning from high level



Source: Robeco, Bloomberg; 30 June 2023

Chart 4. Forward inflation stable around 2.5%



Source: Robeco, Bloomberg; 30 June 2023

European Central Bank: insurance has a price

- Risk of 4 handle on depo rate as ECB bases policy on incoming core CPI data rather than inflation outlook
- Earlier end to full PEPP reinvestments seems more likely than APP bond sales
- Still braced for downtrend in yields and steeper curves in H2

Policy no longer forward looking

As widely expected, the ECB delivered a further 25 bps policy rate increase in June, bringing the cumulative rise in the deposit facility rate in this cycle to 400 bps (i.e. from -0.50% to 3.50%). "Inflation has been coming down but is projected to remain too high for too long", the statement read. Moreover, it highlighted that "future decisions will ensure that … rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to the 2% medium-term inflation target...". This demonstrates that even as "past rate increases are being transmitted forcefully to financing conditions", there is a bias in the Governing Council to lift policy rates even further. Lagarde reinforced this at the press conference by stating that the ECB was "not yet at destination", still had "ground to cover" and would very likely continue to raise rates in July – unless there was a material change in the baseline economic outlook. Here she stressed that the ECB's staff had revised up its core inflation projections for this year and the next.

Since the June meeting, through speeches of policymakers, we have learned more about the ECB's current reaction functions and intentions for the coming months: the ECB is unlikely to stop hiking until core inflation has decisively turned the corner. Through this the central bank wants to 'insure' against a scenario in which inflation stays more persistent than expected – as Executive Board Member Isabel Schnabel has explained. We would argue though that by no longer basing policy on *expected* future inflation but on realized core inflation (which historically has tended to lag trends in headline inflation – which is projected to fall to 3% or below in Q4, energy prices permitting) one opens the door to overtightening risks. In other words: an anti-inflation insurance policy likely has a price.

That said, our best guess is that core inflation in the Eurozone, at 5.4% in June after 5.3% in May (and 5.7% in March), should resume its gradual downtrend over the coming three to six months. This might not occur fast enough to prevent a July hike from being followed up by another one in September, assuming growth and lending data do not massively disappoint. But it should be sufficient to forestall a further 25 bps rise to above 4% in October. Note that a 4% depo rate is fully priced in by markets (see Table below) and that two more Bank Lending Surveys will be released before the October meeting (the one upcoming after July and September). An extra consideration is the possibility that the ECB – instead of hiking rates to 4% or higher – signals an earlier end to the full reinvestment of redemptions coming due in the PEPP portfolio, which currently is anticipated "until at least the end of 2024". This seems more likely than APP bond sales.

What is priced in for the ECB versus our expectations

ECB deposit facility rate	*3.50*	Sep-23	Dec-23	Mar-24	Jun-24
Change implied by OIS (bps)		39	49	45	31
Our probability-weighted expectation (bps)		38	36	10	-25
Our central scenario (bps)		25	25	0	-25
ECB depo rate in central scenario (%)		3.75	3.75	3.50	3.25

Source: Bloomberg, Robeco; 3 July 2023

DBR curve	Spot yield	12m Fwd	Carry* (bp)
2y	3.28	2.55	-33
5y	2.62	2.28	-26
10y	2.45	2.30	-9
30y	2.41	2.33	-5

* for a 1pd position in cash bonds over 12 months

Source: Bloomberg, Robeco; 3 July 2023

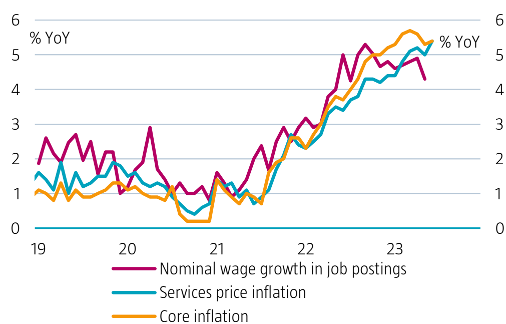
In any case, we suspect that if the ECB were to hike the depo rate to 4% or above, this would likely amplify the economic damage and disinflation pressure further out, and hence fuel speculation about a policy reversal in 2024 and 2025. On

the latter, we still believe that the depo rate will return to below 2.25% – which marks the upper end of our estimated neutral policy rate range – sooner than markets currently anticipate. Indeed, we continue to question the market's belief that the ECB's rates policy will stay restrictive for years to come, despite the projected drop in headline inflation (see Chart 3).

Still braced for downtrend in yields and steeper yield curves in H2

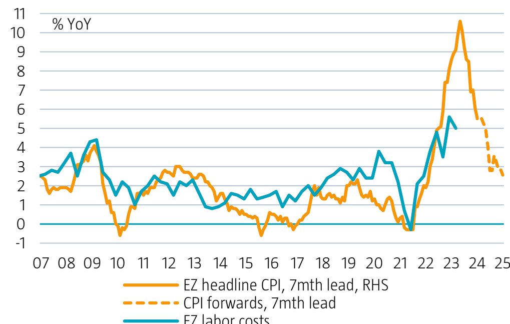
- Since the lows of mid-March, when bond markets were under the spell of the US regional banking crisis, German bond yields have been on an uptrend again. The rise has been led by the front end of the yield curve, as markets again assume a 'terminal' ECB depo rate with a 4 handle – and have significantly reduced the amount of easing anticipated for 2024. As a result of this, and due to some net swap spread re-tightening, the 2-year German yield is close to the highs prevailing in late February. The 10-year yield has re-risen less, remaining (at least) 25 bps below the late February peak of 2.75%, as forward rates further out remain better behaved. Still, at around 2.7%, the EUR 5-year OIS rate 5-year forward – assuming term premium and OIS-policy rate wedge adjustments cancel each other out – still exceeds the 2% median analyst estimate of the long-term 'neutral' depo rate. We are (also) not convinced that a looser fiscal policy regime rationalizes an uplift in the long-term neutral rate to 2.5% or above.
- While valuations thus hint at being constructive on EUR duration from a medium-term point of view – we still target a return of the 10-year German yield to below 2% later in the year or early 2024 – we remain prudent in adding duration (certainly in cash Bunds as opposed to swaps, given the remaining potential for swap spread tightening). This is because we think that, given the ECB's new, more backward-looking reaction function, markets will be slow to price in much-lower implied policy rates over the next few years, notwithstanding the subdued growth outlook.
- Curve-wise, our favorite strategic position remains a 10s30s steepener, especially in swaps, where inversion is still more extreme by historical standards. This takes into account the notion that 10s30s, as in 2008, are less vulnerable to late-cycle flattening than 2s10s – although the latter curve segment should also start to mean revert once clarity has emerged on the timing of the last ECB rate hike. Note that curve steepener positions should be less vulnerable to a (further) secular rise in the long-term 'neutral' rate than an overweight outright duration position.

Chart 1. ECB fears wage growth will keep services & core CPI elevated



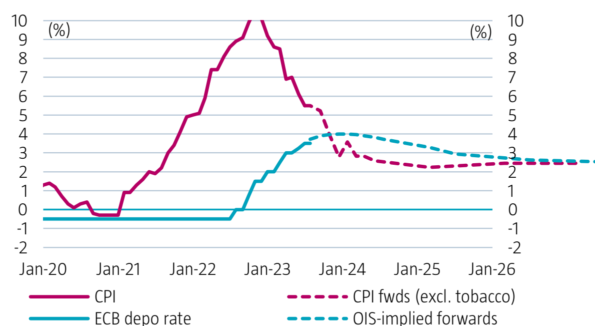
Source: ECB, Indeed, Robeco; 3 July 2023

Chart 2. ..but wage growth should follow headline inflation lower



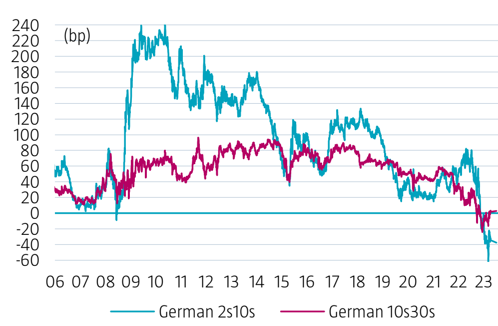
Source: ECB, Robeco; 3 July 2023

Chart 3. ECB policy rate and inflation forwards



Source: ECB, Robeco; 3 July 2023

Chart 4. German 2s10s and 10s30s yield curve



Source: ECB, Robeco; 3 July 2023

People's Bank of China: change of heart

- Narrative about China's recovery has abruptly changed as debt worries resurface
- Market's hiking bias gives way to further easing hopes, though FX weakness limits room
- Secular downtrend in China bond yields still intact – but await yield back-up before adding

Well, that went fast

In our last update from April we were already skeptical about the positive spillovers from China's reopening to the global economy and the strength of China's economic recovery more broadly. But even we are surprised by the speed at which the narrative about the reopening-led recovery has darkened, in the face of the disappointing pace of consumer spending, fading momentum in housing demand, sluggish recovery of credit growth and renewed spotlight on debt-plagued local government funding vehicles.

Surely, policymakers must be disappointed too. Indeed, after guiding banks to lower maximum deposit rates in May, the PBoC in June decided to implement a 10 bps cut in both the 7-day reverse repo rate (currently: 1.90%) and 1-year MLF rate (currently: 2.65%) – which fed through into similar-sized cuts in the 1- and 5-year Loan Prime rates (LPRs) as well. Our central scenario from April had envisaged stable policy rates in the remainder of 2023, although we still assigned a small probability to a further policy rate cut – and argued that rate hike expectations were premature given the amount of leverage in the economy and within the local government sector in particular.

To promote growth, fresh fiscal and property easing measures are likely to be rolled out after the Politburo meeting at the end of July at the latest. But FX weakness, in our view, reduces the room for the PBoC to implement further policy rate cuts in the coming months. We note the central bank has already steered money markets rates such as the 7-day repo fixings of banks below the policy rate corridor (of 1.90-2.65%) (Chart 1) and recently decided to expand its relending facility for the agricultural sector and small businesses by CNY 200 bn in total. To be sure, with core inflation seemingly stuck below 1% and headline inflation hovering close to 0% YoY, the case for an easing bias is clearly there. All in all, our central scenario for the next three months now envisages one further cut in the required reserve ratio (RRR) of banks – the last one dates from March. Further out, we do see downside risk to market pricing of policy rates (see Table below).

What is priced in for the PBoC versus our expectations					
PBoC 7-day reverse repo (%)	*1.90*	Sep-23	Dec-23	Mar-24	Jun-24
Change implied by forwards (bps)		-9	-9	-4	-1
Our probability-weighted expectation (bps)		-3	-4	-8	-12
Our central scenario (bps)		0	0	-10	-10
PBoC 7-day reverse repo in central scenario (%)		1.90	1.90	1.80	1.80

Source: Bloomberg, Robeco; 3 July 2023

Chinese government bonds outperformed their DM peers in the second quarter, as a result of which the 10-year UST-CGB spread widened back to the upper end of the year-to-date range (Chart 3). Given valuations, the central bank rates outlook presently priced in by markets, and the outlook for Chinese bond supply, we currently recommend being tactically underweight CGBs cross-market against DM government bonds. But the secular downtrend in Chinese rates remains intact, in our view, and we would use backups in yields of 25 bps or more in 10-year CGBs to turn more constructive again. We note the IMF in their latest *World Economic Outlook* also projected a further sharp fall in equilibrium interest rates in China over the coming years.

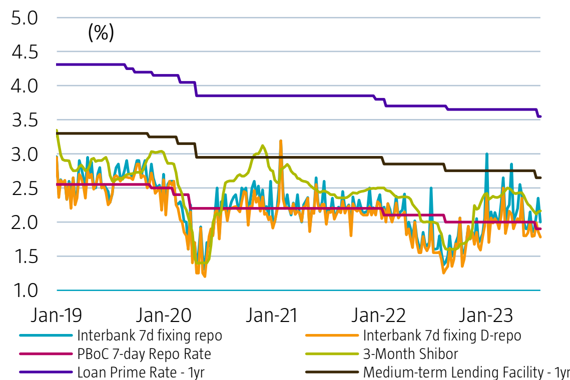
CGB curve	Spot	12m Fw
2yr	2.12	2.38
5yr	2.40	2.67
10yr	2.63	2.78

Source: Bloomberg, Robeco; 3 July 2023

Economic barometer: heading south again

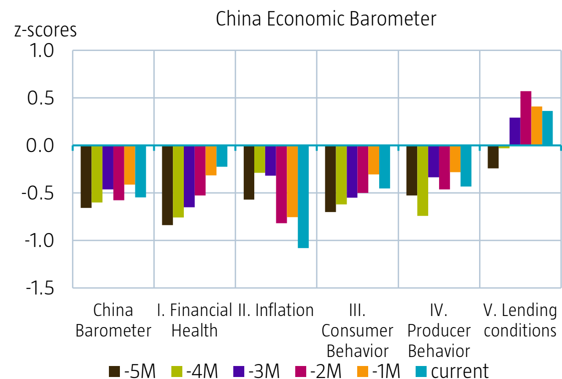
- Our economic barometer for China had been improving earlier in the year, but this has reversed sharply more recently – in line with market sentiment. The loss in economic momentum has been fairly broad-based across the varying components (Chart 2).
- The deterioration in the Z score for the 'producer behavior' component has been mainly driven by a sharp slowdown in rail freight traffic and industrial output growth, as well as by the dip in the PMI new orders index to below 50.
- Meanwhile, the Z score for 'inflation' has weakened further due to the ongoing slowdown in producer price inflation and subdued underlying inflation pressures. And the Z score for 'lending conditions', albeit still in positive territory, is down due to a relapse in the closely-watched credit 'impulse' metric, which factors in the flow of credit relative to GDP, as well as in M2 growth.
- The 'consumer behavior' component – which was the most negative at the start of the year – has also shown renewed signs of weakness. This mainly reflects a reversal in retail, car and home sales growth as well as an even more subdued marginal-propensity-to-consume metric (based on household demand deposits relative to savings deposits). The latter subcomponent's lingering weakness already provided a timely warning sign that not all Chinese consumers were intent on going on a 'revenge' spending spree post-reopening.

Chart 1. Selected policy and money market rates



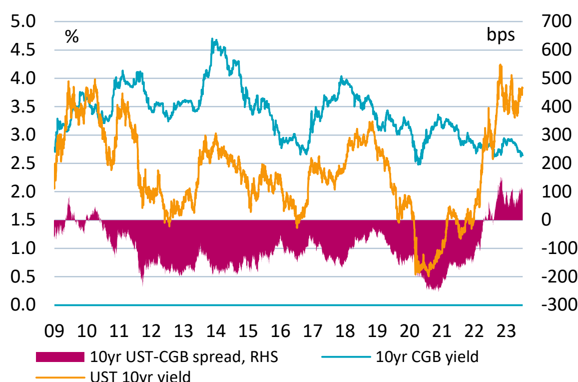
Source: Bloomberg, Robeco; 3 July 2023

Chart 2. Economic Barometer: U-turn



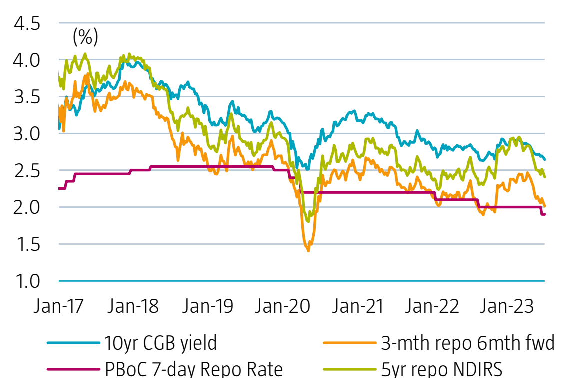
Source: Bloomberg, Robeco; 3 July 2023

Chart 3. 10-year UST-CGB spread



Source: Bloomberg, Robeco; 3 July 2023

Chart 4. Selected short-term and long-term rates



Source: Bloomberg, Robeco; 3 July 2023

Bank of Japan: policy trilemma

- Something's gotta give
- Divergence within the BoJ
- Rates on the rise

Something's gotta give

The yen has come under depreciation pressure again by markets as the BoJ keeps emphasizing a dovish policy stance, like they did in the June meeting, while US economic data continues to remain strong keeping upward pressure on front-end US yields. The BoJ continues to signal that inflation outcomes and expectations have not accelerated enough to reach their respective price stability target in a sustained and stable manner, thereby widening its divergence with other central banks around the world. As the yen weakened again over the past few weeks, the Japanese authorities verbally tried to intervene, with the Ministry of Finance (MoF) stressing that these moves are too rapid. Furthermore, the MoF clearly stated that they cannot rule out any options when it comes to preserving a stable currency, which in our view is a threat to intervene in currency markets. Whether that is a credible threat remains to be seen as past JPY interventions turned out to be short-lived with limited effects as those interventions typically coincided with QE purchases at the same time pushing down JGB yields.

We often wrote about the trilemma of international finance when it comes to the BoJ, which states that an independent central bank and a stable currency are incompatible on the premise that capital flows freely. With the Fed and other central banks continuing to hike policy rates, the BoJ will likely need to accept the possibility of further JPY depreciation in the near term if it sticks to its dovish policy stance. The MoF and the government might take a different view as a weak yen might fuel some additional inflation (via imports) and might lead to some financial stability risks. So something's gotta give!

Divergence within the BoJ

Interestingly within the BoJ some divergence is appearing on the appropriateness of the current monetary policy mix. The summary of opinions from the June Monetary Policy Meeting (MPM) revealed that some policy board members were divided in their assessments of the price trend especially on the upside. Indeed the minutes of the June meeting revealed that there is a growing awareness of the upside risks of inflation and further wage developments. It is interesting to note here that inflation expectations in surveys conducted by the BoJ have been rising very steeply among households for near-term and long-term inflation tenors. The summary of opinions of the June meeting also revealed that price pressures continue to spread across the economy (companies are passing on a larger portion of their input costs), inbound tourism demand is recovering strongly, while the labor market continues to remain relatively tight. It seems to us that this means the BoJ is likely to be forced to acknowledge that their previous inflation forecasts have been too low and will need significant upward revision as early as the next July meeting. So the tide is turning.

What is priced in for the BoJ, versus our expectation

Policy balance rate (%)	*-0.10*	Sep-23	Dec-23	Mar-24	Jun-24
Change implied by futures (bps)		-2	-2	-2	-2
Our probability-weighted expectation (bps)		0	0	6	7
Our central scenario (bps)		0	0	10	10
Policy balance rate in central scenario (%)		-0.10	-0.10	0.00	0.00

Source: Bloomberg, Robeco; 3 July 2023

Inflation has become increasingly persistent, especially for service components of the basket as passing on higher input costs and labor becomes more widespread. Underlying inflation (excluding food and energy) has now been above 2% for some time and has continued to increase steadily now for 12 months in a row. In past Central Bank Watchers, we have previously referred to the upside risk of headline wage hikes as a result of the Shunto talks and tight labor market. We also see some evidence that higher inflation expectations are becoming a bit more entrenched and to us this is evidence that the Japanese economy is shifting to a new regime, thus signalling an exit from the famous deflationary regime.

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Additional wage increases may propel services and core inflation further, feeding into higher inflation expectations and fuelling wage demands as a result.

Rates on the rise

This year's Shunto results are similar to those seen just before deflation took hold in Japan. We consider this to be crucial evidence that Japan is shifting towards a new inflation equilibrium. We expect core inflation to settle between 1 and 2% for the medium term. Such a new inflation equilibrium is starting to get noticed by the BoJ. With underlying price pressures continuing to build further, especially in services, and with much stronger wage growth, we believe the BoJ is ready to pivot away from its current accommodative monetary policy mix as early as the July meeting.

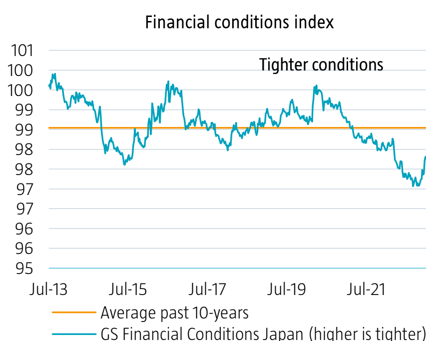
We have written in previous CBWs a lot about the negative side-effects of years of negative interest rates and yield-curve-control (YCC) policy. We think current inflation and wage dynamics will provide a window of opportunity for making changes to the policy mix and, from a sequencing perspective, we think the BoJ will provide an updated inflation forecast at the July meeting acknowledging a much firmer inflation environment in Japan. That will give the BoJ the opportunity to make changes to their YCC mandate. July and September are both live meetings for either a widening of the bandwidth from 50 bps to 100 bps, or the BoJ will shift the target from 10-year JGBs towards 5-year JGBs. Either way, the outcome for the 10-year JGB yield will be to trade closely to 1% yield at the end of the year. In both scenarios we expect 10s30s to flatten further given the large upward pressure on 10-year JGBs. As JGB yields adjust higher over the course of 2023 relative to other markets, we continue to look for a stronger yen versus other major currencies. As the BoJ starts making changes to YCC while other global central banks will reach their respective terminal rates later this year, we see value in taking long positions in the yen at some stage.

JGB Curve	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	-0.07	-0.04	-0.9	1.1
5yr	0.06	0.18	7.5	8.3
10yr	0.40	0.58	12.4	12.8
30yr	1.24	1.34	7.5	7.7

* for a 1pd position over 12 months

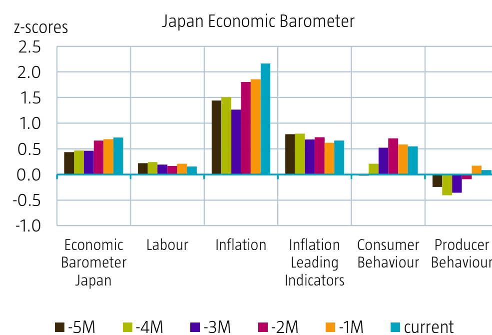
Source: Bloomberg, Robeco; 3 July 2023

Chart 1. Still loose financial conditions



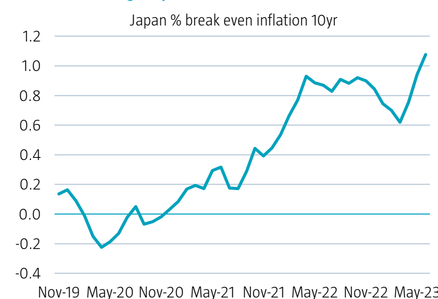
Source: Goldman Sachs, Bloomberg; 3 July 2023

Chart 2. Strong inflation momentum



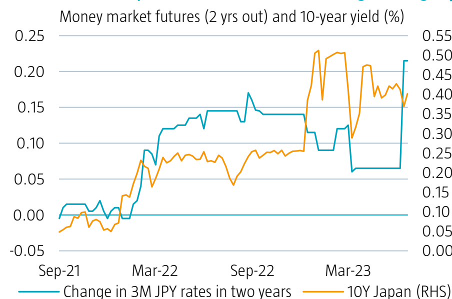
Source: Robeco, Bloomberg; 3 July 2023

Chart 3. Strong improvement in breakevens



Source: Bloomberg; 3 July 2023

Chart 4. Markets price in small amount of tightening 2 years out



Source: Bloomberg; 3 July 2023

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