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THINK Ahead: We're forecasting fewer rate hikes than markets. Could we be wrong?

After this week s hawkish antics at the ECB, markets are pricing in loads more rate hikes, with no cuts in sight. At ING, we re not convinced. **James Smith** argues that it all comes down to whether the inflation shock has simply been delayed, and whether the neutral rate is genuinely on the rise

Markets are increasingly pricing in further rate hikes from major central banks

How markets could be right – and us wrong – about central banks

It takes a lot for a central bank to deliver a hawkish surprise these days. Yet the ECB managed exactly that this week. Two-year swap rates, a gauge of rate hike expectations, rose sharply following Thursday's meeting, helped along by the continued grind higher in energy prices.

I'll confess, this surprised me. With markets already pricing another two rate hikes beyond September, it felt odd that the ECB would risk adding fuel to the fire. But President Christine Lagarde had plenty of opportunities to gently push back on market pricing and didn't take them. The fact that the ECB explicitly left the door open to an October hike in its now-notorious post-meeting leak felt particularly telling.

There are good reasons to be sceptical, as Carsten explained in his post-meeting write-up. For one thing, Lagarde's assertion that inflation will be "longer lasting" than previously expected stands in sharp contrast to what both the inflation figures and corporate pricing surveys are telling us.

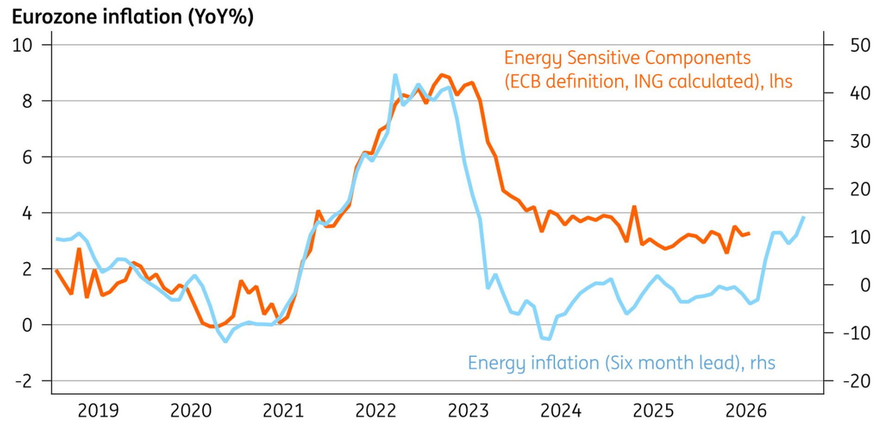
Still, it pays to be open-minded. And it has prompted me to think about how we at ING could be wrong, not just about the ECB, but central banks across the board.

The first possibility is that the inflation shock is simply delayed.

Food inflation and other energy-sensitive parts of the basket have so far proven more benign than feared. But most models suggest the full impact of an energy shock takes at least 12 months, often closer to 18, to come through. And with the scars of 2022 still fresh, perhaps businesses were simply better prepared this time.

Think about Europe's airlines, which entered this crisis well hedged, or European fertiliser inventories, boosted by stockpiling ahead of last year's carbon border tax changes. But these buffers don't last forever. Margin pressure will surely grow.

There's little sign of broader inflationary pressures in Europe – yet



Source: Macrobond, ING

Then there are the surveys.

A few years back, I vaguely recall someone at the Bank of England bemoaning the fact that firms were saying one thing about their pricing plans then doing something else entirely. For some time, 'realised price growth' was running well above 'expected price growth' in the Bank's business survey. Businesses may simply be underestimating their own pricing power again.

Even if all of this is true, though, and firms do pass on higher energy costs more forcefully, someone still has to pay. And here, I think all roads still lead back to the labour market. Workers simply don't appear to have the bargaining power they enjoyed in 2022.

But what if that's wrong too?

One increasingly popular argument among central bankers is that workforce growth has slowed dramatically. Migration has slowed, populations are ageing and labour supply growth is weak in lots of major economies. That means you no longer need especially strong job creation to keep unemployment stable. So if you're getting big increases in job numbers, as we saw in the US in August, then the theory goes that the slack in the economy is shrinking. When that happens, inflationary pressure tends to follow.

Personally, I'm not all that convinced. Wage growth looks relatively subdued across most major economies. And it means consumers ultimately feel the pinch if inflation rises more quickly.

In other words, central banks either stop short of more aggressive rate hikes, or they are eventually forced to reverse course as weaker growth takes its toll.

That is not what markets are pricing right now. Investors are pricing four more ECB hikes, and similar from the Bank of England. But the bit that gets much less attention is that investors never expect rates to come down again. Market pricing has the ECB deposit rate at 3.5% a year from now – and staying there for at least four years.

For that to be true, the neutral rate must have risen. Or in plain English: the current level of interest rates is too low, too accommodative, for the economy we're facing over the next few years.

Now, nobody actually knows where the neutral rate is in real time. And to her credit, Lagarde acknowledged that this week (though having previously said it lies between 1.75-2.5% in nominal terms). Hiking further would take it beyond that, which is one reason Carsten is sceptical that it will happen. Markets clearly disagree with us.

At one level, investors may simply be looking at growth in Europe and the US and concluding that monetary policy isn't doing much.

We already know that European defence spending is rising. German infrastructure investment is too – and new orders are showing some green shoots. Governments may also end up absorbing more of the energy shock if it keeps getting worse, just as they did in 2022, even if that's hard to believe with the current level of bond yields.

Then there's AI. Of all the arguments for structurally higher rates, this is probably the strongest. The enormous investment pouring into data centres, power infrastructure and everything else besides implies enormous demand for capital. More demand for capital should mean a higher cost for that capital, or higher interest rates.

There is a case to be made that this is happening in the US. It's Fed Chair Warsh's strongest argument for higher rates, even if we're much more sceptical about his take on inflation. My colleague James Knightley expects a rate hike next week but is less convinced about the need for more.

As for Europe, I'm just not so sure.

Another ECB hike? Maybe (though not our base case). But a world where rates rise and never come down requires a bigger story: a delayed inflation shock, structurally tighter jobs markets and higher neutral rates. For now, that feels like a lot to believe all at once.

Then again, with energy prices only going in one direction right now, it takes a brave investor to bet otherwise.

James Smith

THINK Ahead in developed markets

United States (James Knightley)

- **Fed Rate Decision** (Wed): The Federal Reserve decision is the critical event of the week. In the wake of Fed Chair Kevin Warsh's hawkish realignment at the Jackson Hole Symposium, markets moved to pricing a two-thirds probability of a rate hike (and to 90% after the hot inflation data). Ahead of that speech, we thought the Fed had room to be patient, with our job market and inflation forecasts suggesting a prolonged pause well into 2027 was the most likely path for monetary policy. However, comments about inflation being above target for too long while at full employment in an environment where financial conditions are not viewed as being "tight" mean we now suspect a hike is more likely than not. However, given our macro forecasts, we see this as a one-off recalibration of policy, similar to the single 25bp rate hike in 1997 by Alan Greenspan's Fed.
- **Retail Sales/Industrial Production** (Wed/Fri): In terms of the data, we have retail sales and industrial production which we expect to remain consistent with the US economy growing in a 2-2.5% range.

Canada (James Knightley)

- **Inflation** (Mon): The Bank of Canada has sounded a touch more hawkish recently despite concerns about the implications for economic growth from a re-escalation of tariffs. Annual inflation is likely to move above 3% this week on energy price moves, but we still doubt the BoC will hike this year.

United Kingdom (James Smith)

- **Jobs data** (Tue): The labour market still looks pretty weak, albeit more stable. Outside of the ailing consumer services industry, we expect payrolls growth to stay flat to slightly negative across the private sector. That's helping to keep a lid on wage growth, which at around 3%, remains consistent with the Bank of England's inflation target in the medium-term.
- **Inflation** (Wed): Rising fuel costs are set to take headline inflation above 3%, though we expect to see minimal impact from energy prices across the wider inflation basket. Second-round effects, which is what the Bank of England is most focused on, appear negligible so far.
- **Bank of England decision** (Thur): A muted hiring backdrop, benign wage growth and scant evidence of second-round inflation effects sets the scene for another on-hold Bank of England decision. We expect a 6-3 vote to keep rates unchanged. Will the Bank turn more hawkish in response to higher natural gas prices? We're not so sure it will, given growing confidence among the doves that the energy shock won't morph into a longer-lasting bout of inflation. Read our full preview.

Key events in developed markets next week

Country	Time	Data/event	ING	
		Monday 14 September		
Canada	1330	Aug CPI (MoM%/YoY%)	0.2/3.1	0.5/3
	1330	Aug Core CPI (MoM%/YoY%)	-/-	0.2/2.3
Sweden	0700	Aug CPI (MoM%/YoY%)	-/-	-0.3/0.3
	0700	Aug CPIF (MoM%/YoY%)	-/-	-0.3/0.7
		Tuesday 15 September		
Eurozone	1000	Jul Trade Balance (EUR bn)	-	8.6
France	0745	Aug CPI Final (MoM%/YoY%)	-/-	0.7/2.4
UK	0700	Jul ILO Unemployment Rate	4.9	4.9
	0700	Jul Employment Change (000s)	60	83
	0700	Jul Average Weekly Earnings (3M YoY%)	3.9	4.1
	0700	Jul Average Weekly Earnings ex Bonus (3M YoY%)	3.5	3.5
	0700	Jul Private Sector Regular Pay (3M YoY%)	2.8	2.8
Italy	0900	Jul Trade Balance (EUR bn)	-	4.2
Spain	0800	Aug CPI Final (MoM%/YoY%)	-/-	0.7/4.3
		Wednesday 16 September		
US	1330	Aug Retail Sales (MoM%)	1.0	-0.6
	1900	Federal Reserve Interest Rate Decision	4.00	3.75
Eurozone	1000	Jul Industrial Production (MoM%/YoY%)	-/-	0/0.1
UK	0700	Aug Core CPI (YoY%)	2.7	2.6
	0700	Aug CPI (MoM%/YoY%)	0.5/3.1	0.3/2.9
	0700	Aug Services CPI (YoY%)	3.5	3.4
Sweden	0700	Aug Unemployment Rate	-	7.8
		Thursday 17 September		
US	1330	Initial Jobless Claims (000s)	210	206
	1330	Aug Housing Starts (MoM%)	7.5	-12.4
Eurozone	1000	Aug CPI Final (MoM%YoY%)	-/-	0.4/3.3
UK	1200	Rate Decision	3.75	3.75
		Friday 18 September		
US	1415	Aug Industrial Production (MoM%)	0.3	0.2
Eurozone	0900	Jul Current Account SA (EUR bn)	-	35.1
UK	0700	Aug Retail Sales (MoM%/YoY%)	-/-	-0.5/1.6

Source: Refinitiv, ING

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