PICTET WEALTH MANAGEMENT

Monetary policy transmission weakens, but still restrictive

Rate cuts delayed not derailed

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FLASH NOTE

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SUMMARY

- Recent macro data have come in line with our expectations. **Growth remains solid but not reaccelerating, and there are tentative signs of resumed progress towards disinflation after a Q1 spike**. However, Fedspeak suggests the **threshold for rate cuts has risen** as officials remain patient about the start of an easing cycle.
- As we noted in our last report "*Later and Fewer*", the timing of the first cut hinges critically on the inflationary trajectory and it was a close call between July and September**. We now expect two 25bps rate cuts in September and December.** If inflation proves stickier than our forecast, the risk of just one cut in December or no rate cut at all this year would rise meaningfully. We stick with the view that **the bar is extremely high for a future hike**, as it would take a strong acceleration in inflation, not just inflation being stuck above target, to justify a rate increase.
- One recent thesis popular with investors is that **higher rates are leading to higher inflation**. There are good reasons to think the **main channels of monetary policy transmission have weakened** this tightening cycle. Structural factors related to the debt structure and specific factors related to the pandemic have boosted the economy's resilience and contributed to the declining sensitivity of growth and inflation to monetary tightening.
- However, **rate hikes are still restrictive, not stimulative**. In our view, **the net income effect of higher rates** – that is, the additional interest income savers earn and spend versus the reduced expenditure by debtors facing higher interest costs, **has been less negative than past cycles**. **But at the aggregate level, the effect is still negative rather than positive.**
- Diminished transmission of monetary policy argues for a **shallower easing cycle** once the Fed starts, with **the terminal rate settling above the Fed's estimate of the long-run neutral rate.**

RATE CUTS DELAYED NOT DERAILED

Recent comments from Fed Governor Waller, who has been a bellwether for the committee this cycle, indicated he would need to see **"several" months of good inflation data** to support a rate cut, which might be possible at the end of the year. The latest FOMC minutes also reaffirmed Chair Powell's dovish leanings compared to the median policy maker. With the labor market staying solid, it would be **difficult for the doves to make the case for a rate cut as early as July**.

We have therefore pushed the timing of the first rate cut to September. In our view, **rate cuts are delayed, not derailed**. The latest CPI report showed the first sign this year that inflation may be slowing. **We expect inflation can continue slowing in the months ahead**, driven by a deceleration in wage growth, falling shelter inflation, and a slowdown in certain supercore categories including vehicle insurance and financial services. We have pencilled in core PCE (the Fed's preferred gauge of underlying inflation) averaging between 0.20-0.25% MoM in the next six months, a sharp slowdown from its pace of 0.36% in Q1. If our forecast materialises, 6m annualised core PCE inflation reading would start improving visibly by the September FOMC meeting.

We have previously argued the Fed can of course move around **elections**, and they had. But they may very well consider refraining from making their FIRST policy change so close to the election, so as not to signal great urgency - former president Bill Dudley argued against moving at the November 2016 meeting (six days before the election). We therefore continue to see the **risk tilted towards a later start to the cutting cycle**, with just one rate cut at the December FOMC this year.

The **tapering of QT** (Quantitative Tightening), a slowdown in the pace of the Fed's balance sheet runoff, is on track to start in June. The Fed aims to reduce the size of the balance sheet without causing undue damage to the funding markets. This is **a technical concern and should have little bearing on interest rate policy**.

MONETARY TRANSMISSION IS WEAKER, BUT RATE HIKES ARE STILL RESTRICTIVE

There are good reasons to think the main channels of monetary policy transmission have weakened this tightening cycle. In other words, we believe the short-run neutral rate, the rate at which monetary policy is neither contractionary nor expansionary, has risen.

Therefore, barring a significant deterioration in the labor market, once the Fed starts cutting rates, **this would be a shallower easing cycle with the terminal rate settling above the Fed's estimate of the long-run neutral rate**. (Separately, we think the long-run neutral rate for the US has also risen, a view we discussed in Horizon 2024, our flagship report for the 10 year outlook). We continue to expect a measured pace of rate reductions totalling 100bps in 2025, and a terminal rate for this cutting cycle well above the Fed's current median neutral rate estimate of 2.6%.

In fact, the effectiveness and transmission of monetary policy will be the hot topic of this year's Jackson Hole Economic Policy Symposium.

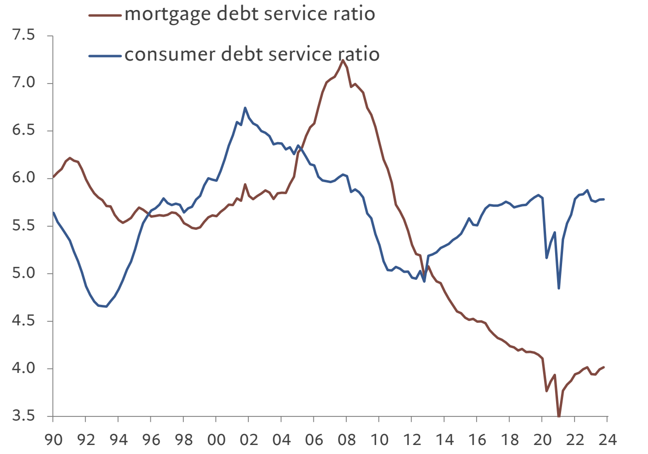
Structural factors related to the **debt structure** and specific factors related to the **pandemic** have boosted the economy's resilience and contributed to the **declining sensitivity of growth and inflation to monetary tightening**.

We have documented in previous notes that households and businesses have **termed out their debt meaningfully** during the low interest rate era post GFC and further **refinanced into ultra-low interest** post the pandemic. More than 90% of US mortgages have fixed rate averaging 3.8%, sharply below the prevailing rate of 7.4%. On the corporate side, 80% of outstanding debt from nonfinancial public firms is fixed rate debt. As a result, **the pass-through of higher interest rates to interest expenses has been dampened -** debt service ratios for households and interest coverage ratios for businesses have deteriorated, but both remain at healthy levels (chart 1 and 2).

Another factor weakening transmission is the **unprecedented fiscal stimulus** during the pandemic. The fiscal deficit is running at a historically high level for an economy at full employment. By our estimate, the stock of excess savings that households accumulated during the pandemic is just begging to get depleted this quarter.

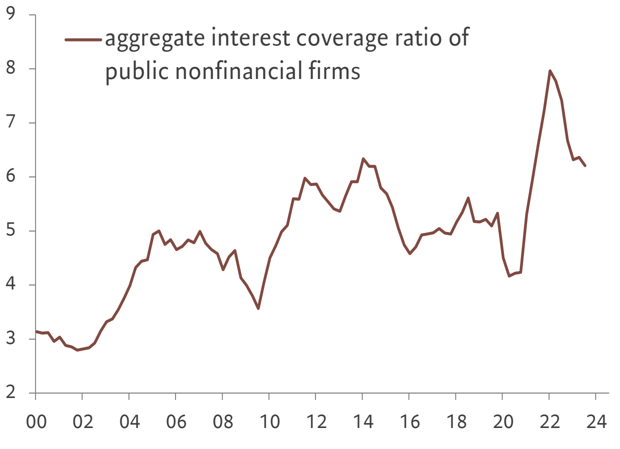
The **significant transfer of savings from the government to the household and corporate sector** has also reduced the effectiveness of rate hikes in fighting inflation. Fiscal stimulus strengthened the private sector's balance sheets, which were already in good shape even before the pandemic stimulus kicked in. Meanwhile, even though the government fiscal situation deteriorated significantly, **interest rate hikes have not led to reduced spending from the public sector.**

Chart 1: household debt service ratios – required debt payments to disposable income



Source: Pictet Wealth Management, FRB, as of 11.04.2024

Chart 2: corporate interest coverage ratio – EBIT to interest expense



Source: Pictet Wealth Management, Compustat, FRB, as of 27.05.2024.

Monetary policy transmission has weakened, but rate hikes are still restrictive, not stimulative. One recent thesis popular with investors is that **higher rates are leading to higher inflation**. The main argument is that higher income cohorts and the baby boomers, which drive the majority of consumption, are benefitting from higher rates and hence continuing to consume at a solid clip. Furthermore, the

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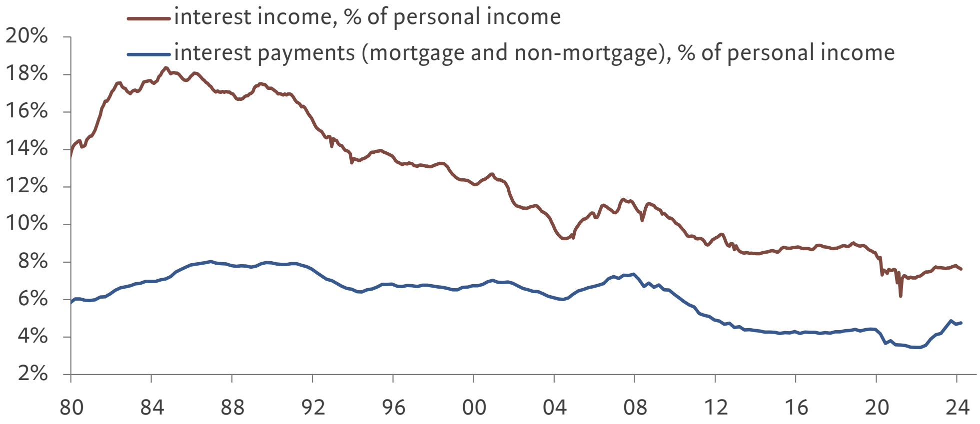
corporate sector has seen their net interest payment come *down* significantly since the start of the hiking cycle.

These points address the income effect of interest rates. In our view, **the net income effect of higher rates** – that is, the additional interest income savers earn and spend versus the reduced expenditure by debtors facing higher interest costs, **has been less negative than past cycles**. **But at the aggregate level, the effect is still negative rather than positive.**

It is true that savers have been accumulating decent interest income from rate hikes. But since the Fed started hiking in March 2022, **interest expenses for the household sector as a whole have risen more than interest income**, by around 1% of total personal income (chart 3). As the tailwinds from the pandemic stimulus fade, lower income households who are the hardest hit by higher borrowing costs, are showing increasing signs of financial distress. Even though their share of consumption is smaller, their propensity to consume is much higher. This is one reason we expect consumption growth to slow (to still decent level) after exuberant growth in the past year.

Chart 3: household interest income vs. interest expense



Source: Pictet Wealth Management, BEA, as of 27.05.2024

Monetary transmission also works through a **substitution effect, whereby high rates raise the cost of current spending relative to future spending, thereby depressing expenditure**. The clearest example is the housing sector, where the transmission of rate hikes was rather immediate and residential investment contracted significantly (chart 4). We are past peak tightening for housing, but unless interest rates decline significantly, we would only expect a limited recovery in home sales.

The same is true for **business equipment spending**, which is less impacted by fiscal stimulus through infrastructure-related bills. Investment there has slowed sequentially since the Fed started hiking rates. Even though cash-rich firms are benefitting from higher interest income[1], on aggregate business are reducing capital expenditures.

[1] Similar to households, there is a wide dispersion of cash positions among firms. We would also note the data showing aggregate net interest payment for the nonfinancial corporate sector is a residual from other items in the National Income and Product Accounts

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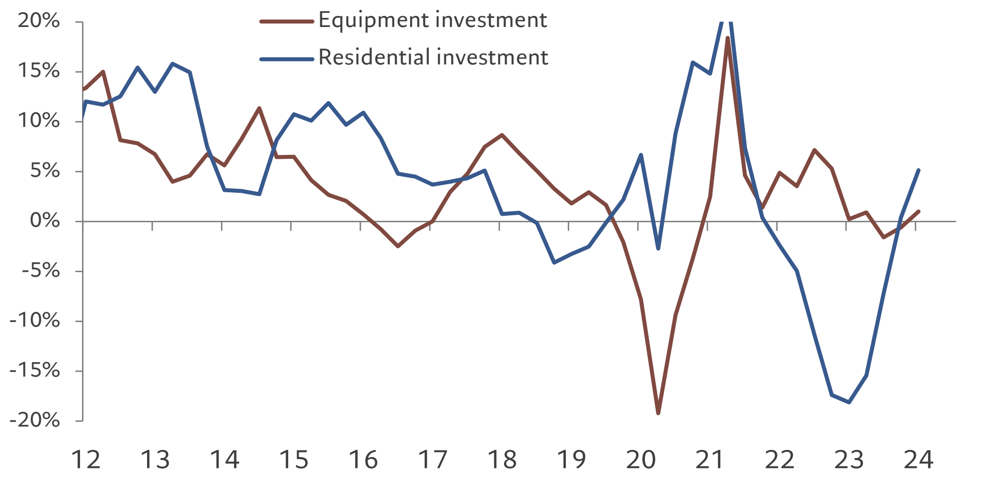
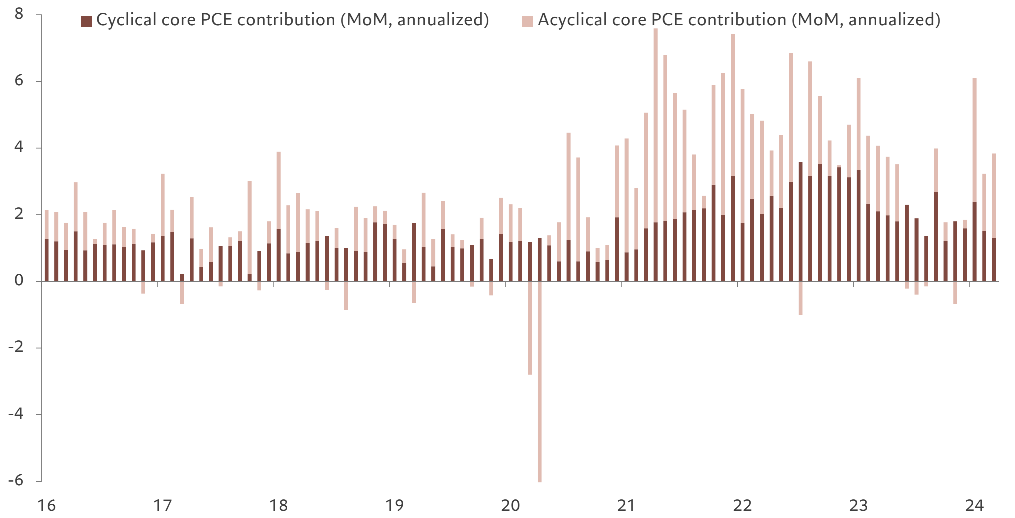
Last but not least, to state the obvious, inflation has declined -not accelerated- since the start of the tightening cycle. This decline is not just due to supply factors normalizing. **When looking at prices of the spending components more sensitive to the unemployment gap, i.e. more cyclical, their inflation rate has also declined (chart 5).**

Chart 4: interest-sensitive investment spending, YoY%, real



Source: Pictet Wealth Management, BEA, as of 27.05.2024

Chart 5: Cyclical and acyclical core PCE inflation



Source: Pictet Wealth Management, BEA, San Francisco Fed, as of 27.05.2024

MACRO OUTLOOK

Where does our assessment of the restrictiveness of monetary policy leave us for the macro outlook? We expect GDP growth to remain strong in Q2 before moderating to a solid, but slightly below-trend pace in H2, along with a benign moderation in the labor market. We expect consumption to slow as a cooling labor market weighs

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on disposable income, borrowing costs remain high, access to credit stays constrained, and savings rate drifts higher. Government spending and investment are likely to slow as fiscal tailwinds fade.

The balance sheets of lower-income consumers are deteriorating, but we expect they can manage their debt burden without causing broader distress. This does raise the sensitivity of lower-income spending to an adverse labor market shock.

Year-over-year core inflation readings will likely flatten out above target due to difficult base effects, but we expect core inflation to decelerate on a month-over-month basis, driven by falling shelter and supercore services inflation. Wage growth should slow gradually, and inflation in vehicle insurance and financial services is likely to decelerate. We also expect some degree of residual seasonality that boosted Q1 inflation to reverse in H2. The process will be bumpy, and core inflation will remain above target in the coming year.

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