GENERALI
ASSET MANAGEMENT

FOCAL POINT

Fed or ECB: Who moves first?

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Our Focal Point series explores topical issues on macro, markets and investment

- **There is quite a lot of speculation on the magnitude, timing, and sequence of the Fed and ECB first rate cuts.**
- **Historically the Fed has tended to lead policy pivots, but evidence is mixed and based on a limited number of cycles. Moreover, the difference in the nature of the 2021-22 inflation spike, more related to the global/supply factor in the euro area than in the US, further weakens the view of the ECB as a follower.**
- **Our new baseline forecast foresees a first Fed cut rates on 12 June. We see a total of 75bps rate cuts this year (vs. 90 bps anticipated by markets), with a risk of just 50 bps being implemented. We do not expect the incoming election to play an important role in the monetary policy decision.**
- **At the same time, we expect the ECB to move ahead of the Fed and start cutting on June 6 on the back of increasing evidence of disinflation. We look for cumulative cuts of 100 bps in 2024. Then the transatlantic yield spread tightening and USD weakness would be postponed.**

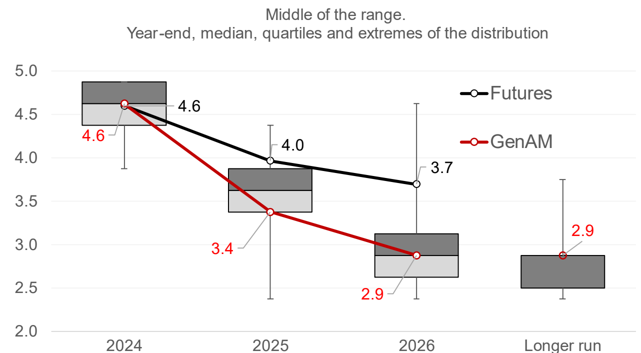
In this Focal Point, we present our revised outlook for the Fed and the ECB and give our answer to two questions that are getting quite popular among investors: Will the November US election affect the Fed decisions? And: will the ECB just follow the Fed in cutting rates rather than acting independently?

Fed to cut by 75bps this year…

We revise our call for the Fed and now expect 2024 only three 25bps rate cuts, starting in June. Risks are roughly balanced, but we warn about the rather high likelihood that in the end, the central bank could deliver just 50bps of easing. Our hawkish revision is due to both recent data and the tone of the communication from the Fed.

Starting with data, the January PCE data provided a sobering surprise, with inflation in ex. housing services ticking up from 3.3% to 3.5% yoy. At the same time, the economy shows signs of deceleration, but it appears far from collapsing.

FOMC "dots" and Fed fund rates forecasts
Middle of the range.
Year-end, median, quartiles and extremes of the distribution

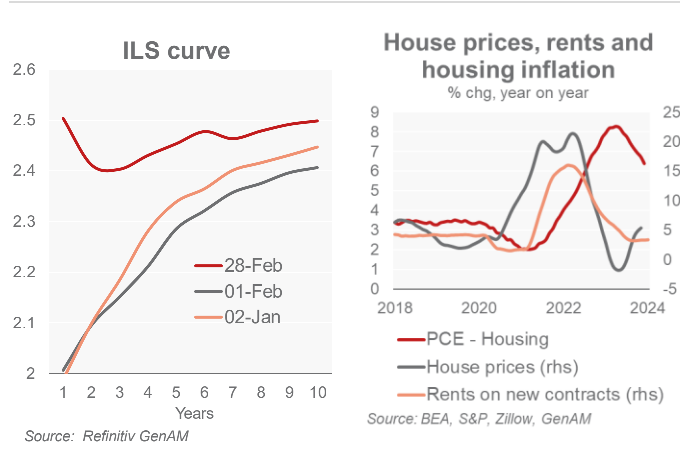


Source:Federal Reserve Board, Datastream,GenAM estimates

After a very strong Q4 2023, Nowcasts for Q1 point to a GDP expansion close to 3% annualised, a bit too optimistic in our view but not pointing to a recession. Consumption remains the key driver, as strong real income is offsetting dwindling

savings (a detailed description of our macro forecast can be found here). We have revised slightly up to 2.4% the growth forecast for 2024, on the back also of a strong carryover (1.3pp). Even with job offers and quits markedly down in recent months, the labour market remains strong, as shown also by the very low unemployment rate (3.9%). Based on this evidence, the FOMC successfully convinced markets that rate cuts could wait longer. Governor Waller explicitly stated that he needs “to see at least another couple of months of inflation data” to assess whether the worrying January CPI data were just a blip. Therefore, by the March meeting, the FOMC will not have enough evidence. By the April 30/ May 1 meeting, however, the Fed will have Q1 data for PCE inflation and its preferred wage measure (the Employment cost index), whose year-on-year growth should be heading to the 3-3.5% range that the Fed deems compatible with the 2% inflation target and this will pave the way for the June cut. We have flattened the rate path and we expect 2025 a cumulative 125bps (five cuts) of easing, to 3.5% (upper bound), followed by two more cuts in early 2026, which will bring the policy rate to 3%, our estimate of the neutral rate. While our view for 2024 is very close to markets diverge significantly for the following years, as futures currently price between two and three cuts in and just one in 2026. We expect core PCE inflation to have landed at 2.1% by the end of 2025, which corresponds to a headline CPI inflation of 2.2%.

Markets have markedly repriced up inflation (see chart below). We acknowledge this upside risk, as the minimal increase in unemployment we have in our forecast (a peak of 4.1% by the end of this year) may dampen the deceleration of wages. Moreover, the rebound in house prices will likely translate into stronger rents with the usual 3 to 4 quarter delay, which risks halting disinflation in early 2025. Therefore, we see some upside risks to our forecast.



…and the election will not matter

There are speculations that the Fed may refrain from cutting rates in order not to give the impression that it favours the incumbent candidate in the presidential election. We can safely rule out such a conjecture, based on both historical evidence and reasoning on the Fed mandate. We looked at the difference between the effective Fed rate and a benchmark given by a standard Taylor rule (details in footnote) and considered the cumulative change between the first and third quarter of the election years against non-election years. The table below shows that the Fed appeared on average “softer” than the benchmark in general (Presidential and Congress) election years, but this result is heavily biased by the Great Financial Crisis (2008 election) and the Covid outbreak (2020). If those episodes are excluded, it becomes evident that the Fed does not behave differently in election years.

More conceptually, we think that the point made in 1992 by the then-President of the Dallas Fed McTeer remains valid. The common assumption is that the Fed is biased toward the incumbent, and therefore it would strive to either avoid a recession or (as in the current context) to make sure that inflation falls ahead of the election. It would then seek to quickly tame inflation and minimise the impact on unemployment, which is however fully consistent with its dual mandate. Therefore, Mc Teer concluded, the incentives of the Fed are aligned, with that of any incumbent President, and there is no reason to think that the electoral cycle may lead the Fed to deviate from its preferred policy stance.

The Fed around elections

Fed funds rate: Q1-Q3 cum. deviation from Taylor Rule		
Year of…	Average	Std. Dev.
	Basis Points	
General Election	-50.4	115.1
- ex recessions	-20.0	89.4
Mid term	-19.2	112.6
No Election	-20.3	114.5

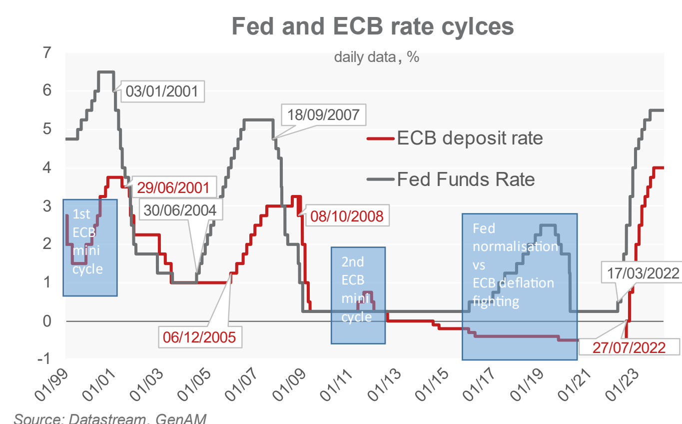
Source: GenAM

However, the outcome of the election may matter a lot for the Fed in 2025, using the possible further deterioration of the federal balance. Both candidates have pledged measures that will further widen the deficit. Even discounting some propaganda and considering the possibility of a split in government (i.e., a Congress without a majority or ruled by a different party from the president’s), a further worsening of the fiscal outlook appears likely in 2025. The Trump-era tax cuts and the expanded subsidies for health insurance both expire at the end of 2025 so Republicans will have to rush to prevent the former, and Democrats the latter. Without a unique majority in Congress and at the White House, there is still scope for a deal that would add around $1tn to the federal deficit. Higher public debt adding to the already elevated private one will help move up the neutral rate, which is the

main reason behind our forecast of a 2.9% nominal r-star, some 40 bps higher than those shown in the December dots. A new Trump presidency moreover brings the risk of sweeping trade tariffs, which are inflationary. It is not fully sure, however how the Fed would respond to that, as they would impact a negative supply shock, raising inflation while depressing activity.

Fed and ECB more independent than it seems.

Will the late and relatively shallow path of US monetary easing influence the ECB? A closer look at the Fed and ECB policy cycles gives a differentiated picture. On the one hand, there is (with a correlation of 0.76 in the 01/1999 to 01/2024 period) a high degree of parallel movement in the policy rates of both central banks. On the other hand, it is also evident



Source: Datastream, GenAM

from the graph below that there were also episodes of decoupling when the ECB either conducted its own mini-cycle (1999, 2011) or even moved in opposite directions as it happened in the 2015-2019 period (with a correlation of -0.64) when the Fed had started to normalize rates while the ECB was still struggling to fight deflation risks. Only after the pandemic, did both central banks exhibit a high degree of synchronisation (with a correlation of 0.96).

The results do not change materially if we consider the so-called "shadow rate" which accounts for the effect of unconventional policies like QE. The key difference is that in the 2014-19 period, there is still a mildly positive correlation (of 0.30) as the Fed still held a sizeable amount of assets due to past QE at that time. That said, in the case of common cycles the ECB never started ahead of the Fed. It lagged by 6 months in 2001, 18 months in 2004/05, 11 months in 2007/08, and 3 months in 2022 behind the Fed. The average lag was 9.5 months. But we would caution to read too much into that. However, the question of who leads the cycle can also be addressed by analysing these policy actions by means of causality in time series (so-called Granger causality). The conjecture that the Fed starts, and the ECB follows cannot generally be confirmed. Instead, there are lots of cases where the hypothesis that the ECB leads the cycle cannot be rejected either (marked in red in the table below) or there is no statistically significant impact in either direction (marked blue). When looking at the policy rates only there is some indication that the ECB follows the Fed with a lag of 6 to 12 months, but this result does not hold when considering only the period until 2014.

The upshot to us is that ECB policymakers do not hesitate to deviate from the Fed's policy blueprint. The 2011 Trichet mini-hiking cycle was conducted irrespective of the Fed and so was the start of large-scale QE by Draghi back in 2015. Looking ahead, we think that several factors again trigger higher diversion among both central banks.

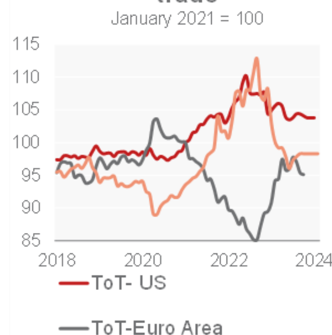
Does the Fed really lead the ECB?

		Lag of policy response						
		1	2	3	4	6	9	12
based on policy rates								
Fed leads ECB	01/1999 - 01/2024	yes	yes	yes	yes	yes	yes	yes
ECB leads Fed		yes	yes	yes	yes	no	no	no
Fed leads ECB	01/1999 - 12/2014	yes	yes	yes	yes	yes	yes	yes
ECB leads Fed		yes	yes	yes	yes	yes	yes	yes
based on Krippner shadow rates								
Fed leads ECB	01/1999 - 01/2024	yes	yes	yes	yes	no	no	no
ECB leads Fed		yes	no	no	no	no	no	no
Fed leads ECB	01/1999 - 12/2014	yes	yes	yes	yes	yes	yes	yes
ECB leads Fed		yes	yes	yes	yes	yes	no	no

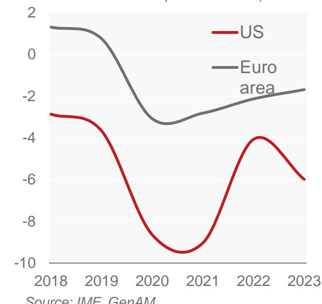
Source: Derived from Granger causailty tests for monthly averages. Green fields confirm the lead of the Fed, red fields indicate impact in both directions, and blue fields show no statistically significant impact in either direction at the 10% significance threshold.

Different causes of inflation key

A key reason for the ECB to behave independently of the Fed at this juncture is the very different nature of the inflation shocks that hit the euro area and the US. First of all, the sharp rise in energy prices following the invasion of Ukraine led to a sharp deterioration in the euro area terms of trade (the ratio of export prices to import prices), while, thanks to its energy independence, the US experienced an improvement. Secondly, the fiscal response to Covid in the US was stronger and longer lasting.



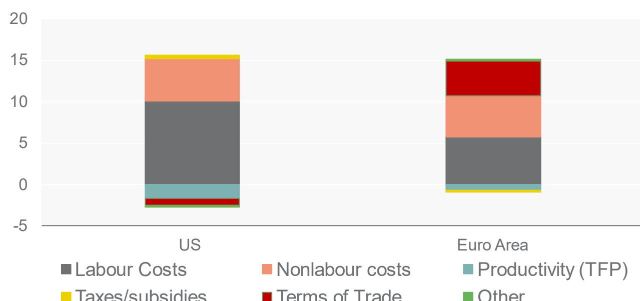
Source: BEA, Eurostat, HWWA, GenAM



Source: IMF, GenAM

As a consequence, while the increase in prices was similar, in the US it has stronger domestic roots (something a central bank has a better grasp on), while in the euro area it was caused to a larger extent by global factors largely beyond the ECB's control[1].

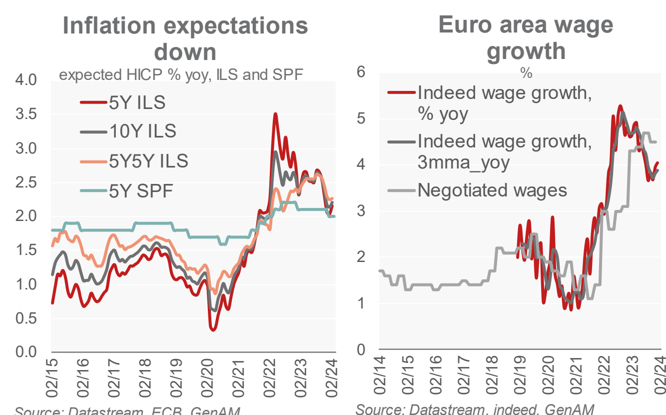
Decomposition of the cumulative CPI change
2019 to 2022



Source: Adapted from Haskel (2023)

Mounting inflation green shoots for the ECB

With the underlying drivers of the euro area price spike abating the inflation dashboard now looks much more favourable from a central bank perspective. As of February, headline inflation receded to 2.6% yoy which is only about ¼ of the 10.6% yoy peak seen in October 2022. And there is an indication that price dynamics will ease further. First, the pipeline pressure is easing as even year-on-year core PPI inflation (excl. construction and energy) has been turning negative in October and import prices have been so already since May. This message is also backed by the ECB's measures of underlying inflation: supercore (3.7% yoy) and PCCI (1.9% yoy) trended further down in January. Second, the crisis-induced energy price spike has run its course. Based on current future prices for oil and gas energy prices will over the course of 2024 no longer be inflationary but neutral to slightly disinflationary. Third, inflation expectations receded from their peaks also over the medium term close to the 2% target again (see graph above). Quite noteworthy, in the ECB Survey of Professional Forecasters the 5Y inflation expectations receded from the 2.2% peak in 2022 to 2.0% in Q1/24 again. Also, consumers' inflation expectations moderated. Finally, in its December macro projections, the ECB sees headline and core inflation at or below 2% from Q3 2025 onwards. With the projection horizon until Q4 2026 this is consistent with the ECB's objective of inflation at target well ahead of the end of the forecast horizon.

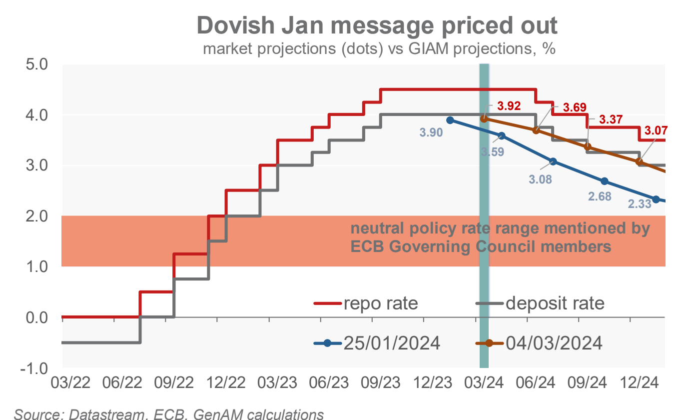


Source: Datastream, ECB, GenAM *Source: Datastream, indeed, GenAM*

Against this backdrop, it did not come as a surprise that at its January meeting the Governing Council switched from the hiking mode to a dovish wait-and-see stance. We think that the update of the growth and inflation projections at the forthcoming March 7 meeting will increase the ECB's confidence in inflation converging towards price stability. That said, there is one major risk on the GC's radar screen which keeps the ECB from taking outright action, namely wage growth. Wage growth soared significantly in response to the inflation spike and stays at elevated levels above 4% yoy. ECB officials continue to emphasise its importance for the underlying inflation trend and President Lagarde referred to important wage settlements taking place in the second quarter of the year to assess whether the inflation outlook is altered for the worse and the ECB needs to act.

Taking the overall inflation picture into account we think that there will be even more inflation green shoots so that the GC embarks on a first rate cut in June. We continue to see the deposit rate at 3.0% by year-end 2024, a cumulative cut of 100 bps, and 2.5% by year-end 2025. .

If the Fed were not to cut by June as well this would have repercussions for the ECB, e.g., the EUR would be slightly weaker than otherwise. But we deem these potential effects not strong enough to derail the ECB's easing cycle.



Source: Datastream, ECB, GenAM calculations

Conclusions

The Fed and the ECB are undoubtedly ahead of an easing cycle. Yet, the different nature of the past inflation spike also leaves room for more heterogeneous policy responses. While

1 See this work by the Bank of England

euro area inflation was to a high degree driven by global supply factors, the cyclical element was much more important for the surprisingly strong US economy. With US economic strength continuing we postponed the expected start of the Fed easing cycle from May to June. Moreover, our analysis shows that the forthcoming US Presidential election is unlikely to impact on the Fed's policy decisions. In contrast, we continue to see the ECB's first rate cut in June as well as there are mounting green shoots on inflation. We would even stick to this view in case the Fed were to cut later. The analysis of past policy action shows that the ECB is relatively independent of the Fed and that both central banks merely react to their respective environment which was sometimes similar in the past.

The risk is that in this cycle the ECB cuts ahead of the Fed which would be historically unprecedented. But this will only nuance our call of mildly declining long-term rates and short-term dollar strength. Should the ECB move first the tightening of the transatlantic yield spread we foresee will just be postponed, as the medium-term direction for the policy rate looks clear. By the same token, the temporary strengthening of the dollar will just delay its descent against the euro which is consistent with the medium-term economic fundamentals.

Imprint

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