CENTRAL BANK WATCHER

Born in the USA

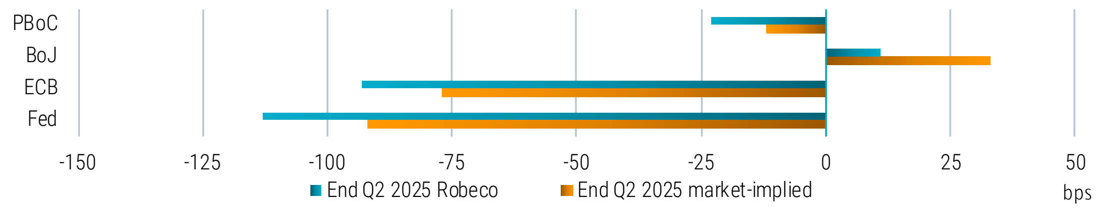
- Fed: narrow path to September cut
- ECB: slow easing cycle
- PBoC: one way travel
- BoJ: keep the faith

Given the slow retreat in services inflation and economic support from loose fiscal policies, central banks are not in a hurry to end their restrictive policy stances. While the ECB has cautiously started its descent from the peak, Fed policy rates are still plateauing. However, more benign inflation data, potentially coupled with further signs of labor market cooling, keep the possibility of a first Fed cut in September alive. Still, with US growth slowing but not yet falling off a cliff, the risk of a first cut after the US elections should not be disregarded.

Meanwhile, the current policy stance of the BoJ and PBoC seems very much 'born in the USA', with FX weakness forcing these central banks into a tighter stance than they otherwise would take. Indeed, despite signs of cooling inflation, the BoJ is expected to announce some form of QT and a rate hike over the next three months. Moreover, we suspect that a further, necessary, rate easing by the PBoC will be delayed until Q4.

The Eurozone, where the ECB remains on track for another rate cut in September, seems more insulated from the impact of the Fed's higher-for-longer policy stance. But, as in the US, long-end bonds, also of fiscally-less-challenged countries like Germany and the Netherlands keep underperforming swap rates. This trend may have further to run as the US elections draw closer.

Figure 1 – Outlook for central banks' policy rates



Source: Bloomberg, Robeco, change by end 2024, based on money market futures and forwards; 1 July 2024

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Marketing material for professional investors, not for onward distribution


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The Federal Reserve: narrow path to September cut

- Further disinflation and slower jobs growth required for rate cuts to become imminent
- Central scenario is still two 25 bps cuts this year, with risk skewed to only one
- Prospects for outright OW UST duration positions improve as growth slows, but not yet

It takes two (more benign CPI reports) to tango

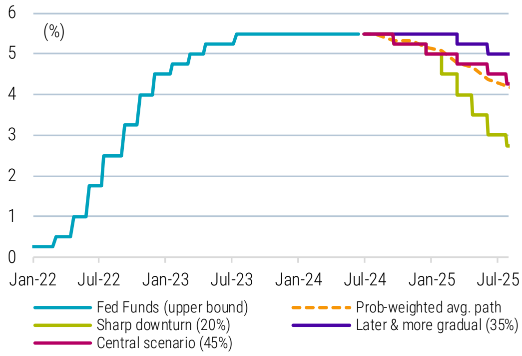
The Fed kept rates on hold in June, but the tone of the statement was somewhat more dovish. In May it had said there had been "a lack of further progress" in getting inflation back to target; now the statement noted there had been "modest further progress".

Indeed, the May CPI and PCE reports showed the monthly pace of core and services ex. housing inflation dropped sharply. However, 6-month annualized inflation rates remain too high. The Fed needs at least two more favorable core inflation prints (i.e. <0.20 MoM for core PCE) before they become sufficiently confident that inflation will return to its target and monetary tightening can start to be dialed back. This rules out a move in July, and means September is the earliest feasible time for the first cut.

In our view, we need to see weaker nonfarm payroll prints (the household survey is already suggestive of a much-cooler labor market). With leading indicators pointing to sub-trend GDP growth ahead, this is feasible. As such, our central scenario remains for a first cut in September, and another one in December, after the US elections. But we agree with the Fed's latest 'dot plot' that the risks are skewed to only one cut this year. In fact, our analysis (see Figure 1) still ascribes a 35% weight to a scenario where the Fed does not cut rates at all this year and only a few times next year – factoring the possibility of higher inflation due to tariffs imposed under a Trump-presidency.

At the same time, we still assign a decent probability to an economic-downturn scenario under which faster rate cuts would emerge. Weighing the three scenarios, our probability-weighted average Fed funds rate path is broadly in line with market pricing for the remainder of this year (see Table 1 below) but somewhat below markets from mid-2025. This largely stems from the fact that our estimate range for the long-run 'neutral' rate (of 3.0-3.5%) – albeit above the Fed's average projection of 2.9% – lies below the ~3.75% implied by current market pricing.

Figure 2 – Three scenarios for the Fed until Aug-2025



Source: Bloomberg, Robeco, June 2024

Downside range break requires sharper slowdown

With nominal GDP growth around 4.5%, a 10-year Treasury yield range of 4.25-4.75% seems reasonable, factoring in fiscal risks and based on a long-run neutral range of 3.0-3.5%. If lead economic indicators start moving south more decisively we would turn more constructive, but for now we are waiting until 5- to 10-year yields are in the 4.50-4.75% area before adding to cross-market overweight UST positions or turning outright long. Curve-wise we remain more constructive on 5s than on 10s and 30s, but acknowledge that a 'higher for even longer' Fed and tariffs pose a flattening risk. In the run-up to the US elections, 30-year US Treasuries are likely to underperform swap rates (even) further.

Table 1 - What is priced in for the Fed versus our expectations

Fed funds rate (% upper bound)	5.50	Sep-24	Dec-24	Mar-25	Jun-25
Change implied by FF Futures (bps)		-15	-40	-70	-92
Our probability-weighted expectation (bps)		-16	-41	-73	-113
Our central scenario (bps)		-25	-50	-75	-100
Fed funds rate central scenario (% upper bound)		5.25	5.00	4.75	4.50

Source: Bloomberg, Robeco; 1 July 2024

European Central Bank: slow easing cycle

- Inflation data hold key to gradual rate cuts
- Base case is 25 bps in cuts per quarter
- PEPP reinvestments first instrument in case of disorderly spread widening

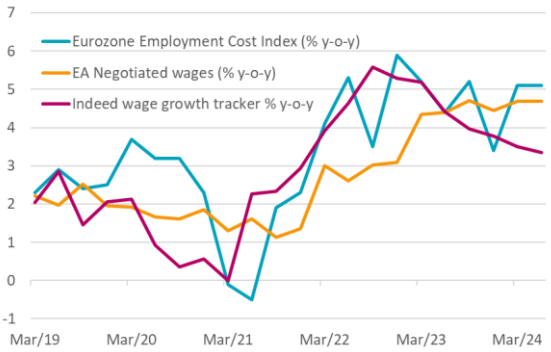
Data dependent ECB permits gradual cuts

In the coming months the room for ECB officials to signal rate cuts will probably be limited. After reducing rates in June, while the staff lifted their inflation outlook, the pressure is on ECB officials to make sure that every subsequent step in reducing rates is supported by the data. More precisely, this support should come from services inflation and negotiated wages data. With the May data on both metrics surprising to the upside and June flash inflation just matching the consensus view, it's likely to take 2-3 months of reassuring data before the Governing Council (GC) members feel comfortable enough with the inflation path to decide on the next rate cut. This basically all but rules out a cut on 18 July. By the time of the September meeting the GC will have seen information on prices for two additional months. We assume this will provide the GC with enough comfort to reduce rates by 25 bps. Another such step could come at their December meeting, which would make this a very gradual easing cycle. As long as jobs growth remains intact and there is little recession anxiety, the motivation for a quicker pace of easing remains low.

Hesitation to act on political unrest

The unrest in Euro government bond markets following the surprise announcement of snap parliamentary elections in France, is making matters more complicated for the ECB. Obviously the recent spread widening lead by French OATs matters for the ECB, but only if it seriously starts to hamper the "transmission" of their monetary policy.
The ECB will want to avoid being seen as sacrificing their inflation credentials to support bond markets. If anything, their response is probably to emphasize this disconnect between market turmoil and their official rates policy. In response to the recent spread widening, President Christine Lagarde mentioned the ECB is "attentive to the good functioning of financial markets". While their attentiveness may provide some comfort, the bar to step in and support markets will probably be high. In the case of a sizeable, persistent, disorderly jump in spreads, the ECB's "first line of defense" would be to decide to change its policy on PEPP reinvestments. As from 1 July the ECB has started to reduce its PEPP portfolio by EUR 7.5 bln per month on average. The plan is to end reinvestments at the end of 2024. Under pressure these plans could become fluid.

Figure 3 – Wage growth has slowed only gradually (%)



Source: Bloomberg, Robeco, June 2024

ECB rate path leads to narrow range for Bunds

The current combination of still strong jobs growth and sticky services inflation limits the room at which rate cuts can be priced in. This should impact the outlook for 5-year German OBLs, which we expect to trade in a range of 2.25-2.75%. Curves remain historically flat. We expect EGB curves to steepen on a combination of sustained sizeable deficits (supply) and expected lower front-end yields.

Table 2 - What is priced in for the ECB versus our expectations

ECB deposit rate (%)	3.75	Sep-24	Dec-24	Mar-25	Jun-25
Change implied by market pricing (bps)		-18	-39	-59	-77
Our probably-weighted expectation (bps)		-20	-45	-65	-93
Our central scenario (bps)		-25	-50	-75	-100
Fed funds rate central scenario (% upper bound)		3.50	3.25	3.00	2.75

Source: Bloomberg, Robeco; 1 July 2024

People's Bank of China: one way travel

- PBoC retains easing bias as growth struggles to pick up and inflation remains low
- Further rate easing likely once FX pressure eases but balance sheet expansion remains the key tool
- Renewed bounce in longer-term yields possibile if some growth recovery ensues, though secular downtrend remains intact

Balance sheet expansion still the name of the game

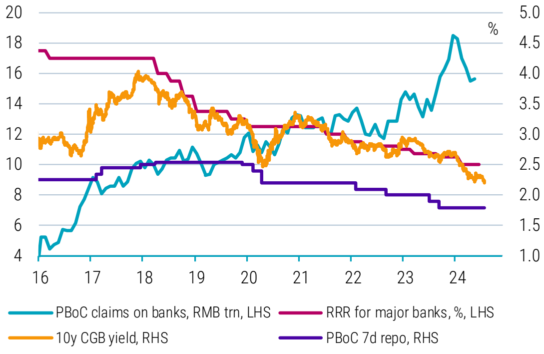
While industry has been in a gradual recovery, helped by exports growth, lingering weakness in other parts of the economy, notably the property sector, has prevented overall economic momentum from improving. Indeed, despite earlier signs of improvement, our Economic Barometer has relapsed again. Meanwhile, inflation has remained subdued as evident from still-weak CPI and PPI data.

Despite the ongoing weak nominal growth backdrop, monetary policy has held steady since the RRR cut in January. Moreover, the latest 10 bps cut in the 7-day reverse repo rate, which will become the key policy rate going forward, dates from August 2023. With FX weakness reducing the monetary room for manoeuvre the PBoC has instead opted for further property easing measures. These include lowering the minimum down payment ratios for home buyers, removing the floor on mortgage rates, and rolling out a CNY 300 bln re-lending facility to support loans to SOEs to buy and convert unsold homes into affordable housing.

So far, such measures have not ignited a recovery in home sales beyond some Tier-1 cities. Land sales by governments to developers have also remained lacklustre. More measures may therefore ensue at the late-July Politburo meeting.

As for monetary policy, we think that balance sheet expansion will remain the primary channel through which the PBoC will support the economy (Figure 4), including via another RRR cut in Q3. We also agree with markets that a 10 bps policy rate cut is likely later in 2H (see Table 3 below), with the timing contingent on when the Fed will start to ease.

Figure 4 – PBoC policy levers – spot the trend



Source: Bloomberg, Robeco, 1 July 2024

CGB yields – verbal pushback

The year-to-date decline in short and intermediate CGB yields has been relentless. Longer-dated yields have also fallen noticeably but bounced sharply in late April and June after policymakers fretted about too-low yields. On July 1st the central bank signalled it would borrow long-term CGBs from primary dealers after "careful observation" of the current market situation.

Policymakers clearly are unhappy with the historically low level of longer-term yields. Indeed, at 2.2% in late June, the 10-year yield was just 40 bps above the 1.8% 7-day reverse repo rate – the last time this occurred was at the lows in 2016, and during the outbreak of the pandemic in 2020. As such, while factoring in the possibility of some improvement on the property side, we opt to retain underweight CGBs cross-market against DM government bonds. However, we recommend a small underweight only, as the *secular* downtrend in Chinese rates has probably not ended.

Table 3 - What is priced in for the PBoC versus our expectations

PBoC 7-day reverse repo (%)	1.80	Sep-24	Dec-24	Mar-25	Jun-25
Change implied by forwards (bps)		-8	-10	-14	-12
Our probability-weighted expectation (bps)		-3	-11	-16	-23
Our central scenario (bps)		0	-10	-20	-20
PBoC 7-day reverse repo in central scenario (%)		1.80	1.70	1.60	1.60

Source: Bloomberg, Robeco; 1 July 2024

Bank of Japan: keep the faith

- Upcoming rate hike
- Confidence in futher inflation path
- Weaker yen

Policy normalization

The recent summary of opinions expressed at the BoJ's June meeting suggests that among policy makers there is increasing confidence regarding the path of policy normalization. The underlying message even points to a possible hike. There seems to be broad agreement that upside risks to inflation have become more "noticeable". Indeed when looking at survey data from the BoJ, the PMIs and Tanking, one can clearly observe that price expectations remain elevated. Similarly, so do wage expectations. We are of the view that when it comes to the future path of inflation things will play out a bit differently.

Indeed, actual inflation outcomes have steadily come down this year with US-style core CPI now under 2% and projected to drop further. Headline inflation trajectory is a bit more bumpy given base effects, however, the trajectory towards the end of the year should see continued disinflation. We feel the economy is not as strong as hoped or projected, as evidenced by hard data like Q1 GDP, household consumption and industrial production. Furthermore, wage data continues to come in below expectations set by Shunto. We think that Governor Ueda agrees with our assessment on the economy and wages and hence continues to sound dovish.

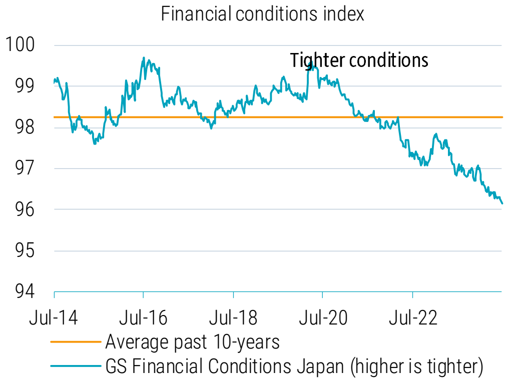
Weak yen

The weak Yen continues to complicate things for the BoJ. Officially the yen is not part of the BoJ mandate but is nonetheless an import policy consideration. Weak yen impacts inflation via the import channel and is therefore able to raise inflation over time. There is also a credibility argument – the weaker the yen gets, the less likely domestics investors will be to buy their own currency. With the yen now close to 161, we feel this is starting to impact the policy direction more than previously. Some sort of stability is required, or at the bare minimum a more behaved path of depreciation. We feel that the BoJ might get cornered by markets to hike, driven by a weak yen, for reasons mentioned above. We consider all meetings for rest of the year as live for rate hikes and for further tweaks to the guidance on QE and balance sheet operations. Yet, one should discount the dovish assessment of the economy and inflation by Governor Ueda. Rate hikes are likely but not a sure thing, as the consensus suggests.

JGB yields to go higher

With these potential policy changes, the outcome will be that the 7-year JGB yield trades close to a 1% yield by the end of Q3 2024, and the 10-year JGB yield close to 1.35%. In all scenarios we expect 10s30s to flatten further given the large upward pressure on 10-year JGBs. As JGB yields adjusted higher over the course of 2024, relative to other markets, and considering FX hedging costs, the 30-year JGB is the superior investment for domestic Japanese investors.

Figure 5 – Loose financial conditions



Source: Bloomberg, Goldman Sachs, Robeco, 1 July 2024

Table 4 - What is priced in for the BoJ versus our expectations

Policy balance rate (%)	0.00	July-24	Sept-24	Oct-24	Dec-24
Change implied by OIS (bps)		6	9	16	21
Our probability-weighted expectation (bps)		3	5	11	11
Our central scenario (bps)		10	10	25	25
Policy balance rate in central scenario (%)		0.10	0.10	0.25	0.25

Source: Bloomberg, Robeco; 1 July 2024