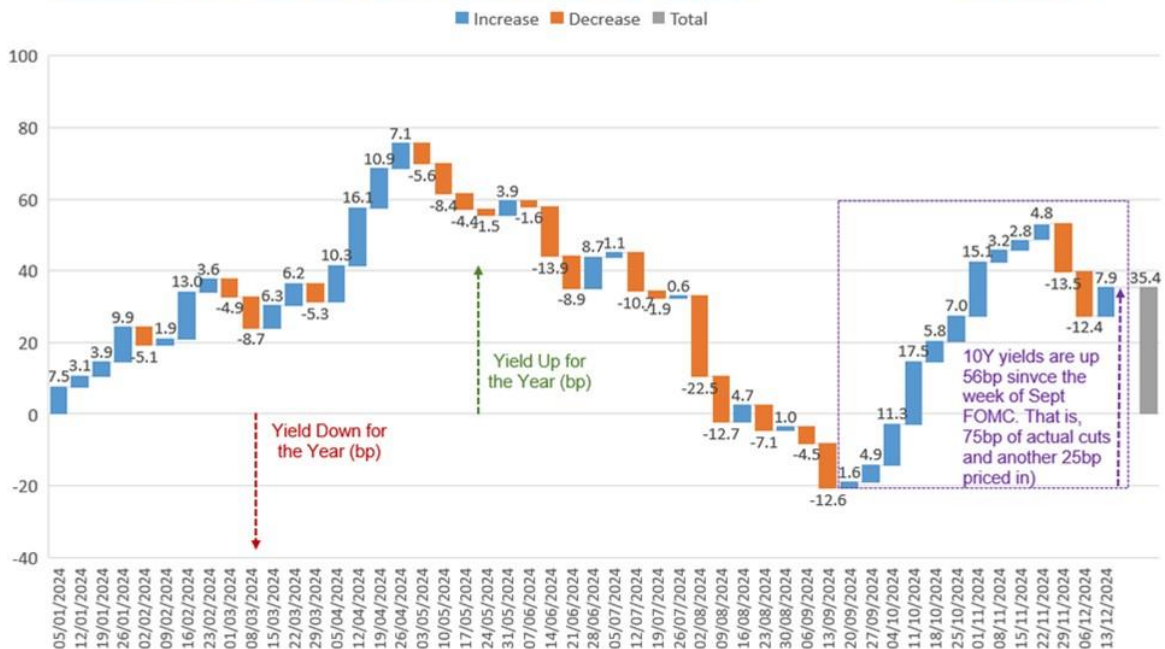


What Central Banks Should Worry About

In a Nutshell:

- Admittedly, **central banks have to weigh off cutting rates too fast** (at the risk of re-igniting inflation) **against being too slow** (lest it triggers an inadvertent hard-landing).
- The notoriously *lagged and variable monetary policy transmissions* render this a greater challenge and **geoeconomic uncertainties only make matters worse**.
- On that note, **stagflation risks creep in**, and that may give central bankers an arguably greater worry they cannot dismiss.
- But **rising yields despite significant rate cuts is the invisible elephant in the room** that may suggest that **impaired monetary policy transmission may be the risk in plain sight we may be missing**.
- **Trouble is, it is too soon to conclude** that given policy lags, and all the noise and disruptions amid elevated geo-economic uncertainties.
- And that suggests the **risk of a lot more turbulence** around the corner.

10Y UST Yields (2-week Avg Chg since end-2023; bp): 10Y Yields are Up 50-60bp since the Sep FOMC & ~40bp on since end-2023 despite 75bp of cuts delivered and another 25bp priced in. This partly **reflects Trump-flation associated with with fiscal/debt woes, (structural) inflation risks associated.** But it also highlights **Easing Impaired!**



- It is widely expected that most G10 central bankers ought to be worried about one of two things.
- Either a **re-acceleration of inflation into a cutting cycle**, potentially inflamed by hard-to-predict, but possibly profound impact from geo-politics and Trump-flation.
- **Or not easing quickly enough, thereby stumbling into a hard-landing** as highly variable lags from monetary policy bite (despite the start of easing cycles).
- Arguably, the sense is that with *US exceptionalism*, the **former is a greater concern for the Fed**.

- Whereas the **latter** (not being quick enough to avert hard-landing risks and attendant economic pain) may be **more applicable across the Atlantic** and broadly **elsewhere globally**.
- **Both risks pertain to appropriately timing** (be it deferring or hastening) the **policy inflection**, with a *follow-up challenge of identifying the applicable “neutral” rates* (to account for potential structural shifts obfuscated by cyclical noise).
- The **good news** is that a **high(ly restrictive) starting point**, after aggressive hiking cycles from 2022-23, provides G10 central bankers with **sufficient buffer to comfortably front-load sizable cuts without fearing policy monumental mis-steps**.
- The **ECB has already delivered a 100bp of cuts**, the **Fed has done 75bp with another 25bp around the corner**. Meanwhile **SNB and Riksbank have pulled off 125bp of cuts**.
- These **cuts** by and large not only **appear to be appropriately timed**, but also **leave scope for further easing into early-2025** as data-evolves.
- In other words, **for most central banks**, the **direction of travel (down) for rates is far more assured**, and the judgment call is more around the pace of cuts for now.
- Nonetheless, this is not to be confused with risk-free policy calculus.
- **Tucked in a corner** is the **cognizance of the worst-case scenario of stagflation** – which delivers cost shocks and destroys demand.
- The trouble with that is not correcting for a policy mistake. Instead, it is having to knowingly endure, if not inflict, greater economic pain under the *tyranny of an inverted Phillips curve**.
- **Discomfortingly for global central bankers, geo-political shocks tend to increase the risks of stagflation-type outcomes**.
- But that said, the **silver-lining** is this time is that **supply-demand dynamics of global energy markets appear to have mitigated the risks of sharp energy shocks**, thereby **diminishing stagflation risks**.
- **What then should central bankers really fret other than timing the pace of cuts?**
- Arguably (although not obviously), central bankers should worry about the **lack of policy transmission** (and hence **impaired policy efficacy**). This may be the **risk in plain sight that is being missed!**
- Fact is, **after effectively 100bp of Fed cuts** (75bp delivered in over Sep and Nov FOMC and another 25b imminently priced in), **10Y UST yields are up 50-60bp** since the Sep FOMC and nearly 40bp for the year.
- Correspondingly, the **USD is up nearly 6%** since the Sep FOMC (and ~ 5.5% for the year).
- This **speaks to tighter, not looser, monetary conditions**. And that is **perverse, given markets are fixated on rapid easing**.
- Admittedly, equities on an extended bull run may loosening financial conditions.
- But the **liquid, positive wealth boost effects accrue to the wealthier households**.
- Whereas most of main street will still be hurting from elevated rates still (with little relief from cuts).
- So arguably, a **blind-side for central banks to worry about is impaired transmission**.
- **Trouble is, given heightened uncertainty** around *geo-economics* and *transmission lags*, it will be **challenging to respond confidently to what appears to be impaired transmission**.
- And so, significant risks of **policy-induced turbulence** is something that **cannot be dismissed into 2025**.

* The correlation between lower unemployment (coinciding with higher demand) and higher inflation is flipped. Thereby ending up with higher inflation that corresponds with, and arguably causes, economic pain (driving unemployment higher) rather than higher growth and demand driving inflation.

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