It's All About Inflation Expectations

Inflation expectations around the world have weakened considerably.

That fact by itself is sufficient reason to expect rate cuts and other policy easing options – from the Federal Reserve and other central banks around the world.

While it is tempting to overthink the Fed and its reasons for cutting and by how much, it’s not necessary to do so.

When boiled down, questions as to whether it be pressure from the executive branch, the needs of the stock market (the "Fed Put"), global risks (as often cited), USD strength, or some other factor, are interesting and perhaps relevant, but not necessary.

One doesn’t need to conjure any “outside the box” thinking to understand why easier policy is on the way.

In orthodox modern central banking (that is, after the Volcker disinflation), the single overriding remit of the monetary authority is to maintain stable inflation over the medium term.

Operationally, this means keeping inflation expectations stable and anchored. It’s an approach shared across almost all central banks in developed markets.

With inflation expectations low and falling everywhere, central bankers globally are focused on getting these expectations back up. While it is likely not consciously coordinated, the worldwide policy response is coincidental. We are witnessing a global
Looking at the US, for example, we have presented evidence that at 2.5% the current policy target in the US is at the neutral rate. Yet inflation expectations are below 2.0% and falling. These simple facts argue for a cut by themselves: rates need to be below neutral to get inflation expectations back up.

But the Fed is not alone and other central banks will be operating within whatever policy space they have to pursue similar policies.

This is one reason why calls to jump on the weaker dollar train need to rely on something other than relative policy differentials.

Every central bank is in some form of the same boat, so policy divergence isn’t the dollar driver that many maintain it is.

Furthermore, it helps explain the strong bid on gold, and suggests that unilateral currency intervention by one country will likely be followed up with similar replies elsewhere; other monetary authorities will most likely make their own money cheaper as well, resulting in an extraordinary round of global liquidity easing.

Whether or not this will assuage downside risks to the global economy will be a verdict rendered by inflation expectations further on down the line. If the central banks are successful, we’ll see rising inflation expectations and steepening yield curves from the back end.

**Falling Global Inflation Expectations**

*SOURCE: BNY Mellon Markets, Bloomberg, data through 8 July 2019*