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Asset allocation: when will enacted policy tightening begin to bite?

Multi-asset | July 2023

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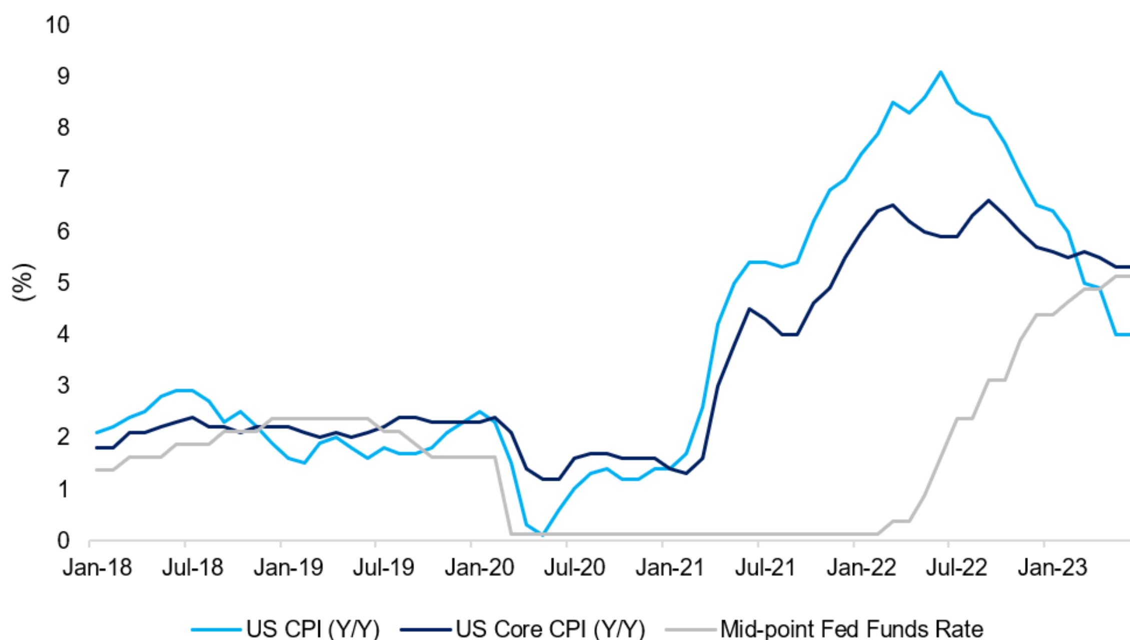
- **Key developed market central banks remain focused on bringing inflation levels sustainably back towards targets**
- **Persistent labour markets and core measures have forced policymakers to tighten policy more than previously anticipated**
- **However, policy changes impact economies with lags, and interpretation of the length of these is key to seeing whether enough has already been done**

As the world emerged from Covid lockdowns over 2021 and into 2022, the focus of consumer demand expanded from goods towards more labour-intensive services areas. Combined with a decrease in the labour participation rate, this spurred a tightening in labour markets and an associated pick-up in wage growth.

Central banks cannot meaningfully impact – and should look through – short-term inflation fluctuations driven by supply-side issues, à la the initial Covid goods-driven inflation and the now-mocked "transitory" phrasing. However, a spread of increased pricing into elevated core inflation and wage growth provided a link to self-sustaining above-target inflation, which is something central banks are mandated to target through policy change. As such, beginning with the Bank of England (BoE) in December 2021, key developed market central banks embarked on a rapid programme of policy tightening aimed at rebalancing supply and demand across economies to equilibria consistent inflation targets (Figure 1).

Figure 1: US inflation versus policy rate

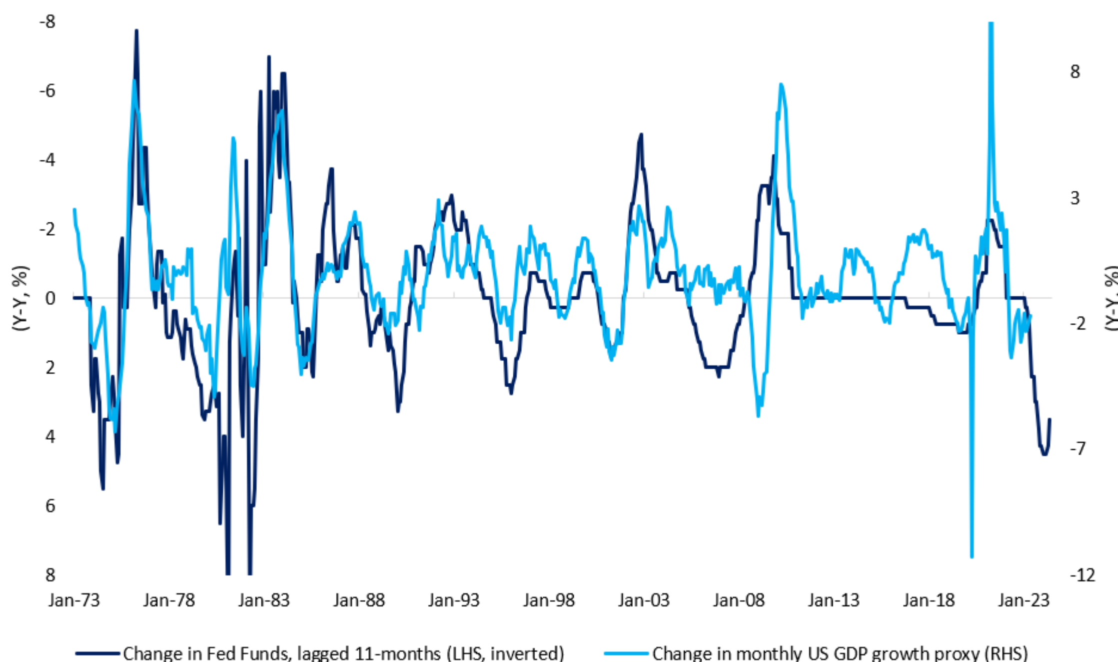


Source: Bloomberg, 30 June 2023

From here the key area of debate is whether central banks have already implemented enough tightening to bring demand sufficiently lower. The extremes in this debate are: “(more than) enough has been done and all that is required is for more time to pass and for the full effects to be felt”; and “the effects have already fully materialised, and more tightening is required to bring core inflation to target”.

This discussion centres around the duration of the lag from any incremental tightening to the associated decrease in demand. We have tested the empirical relationship between changes in central bank policy rates and changes in GDP growth across the US, UK and eurozone. The lag from policy change initiation to economic impact is found to be 11 months in the US (Figure 2), eight months in the UK, and nine months in the eurozone. This suggests that the economic impact of the rate rises began to be felt in Q1 2023 for the US, and in Q3 2022 and Q2 2023 for the UK and eurozone, respectively. However, importantly this work also suggests that the peak impact from implemented rate hikes won’t come until around Q4 2023/Q1 2024.

Figure 2: lagged change in Fed Policy Rate versus change in US GDP growth

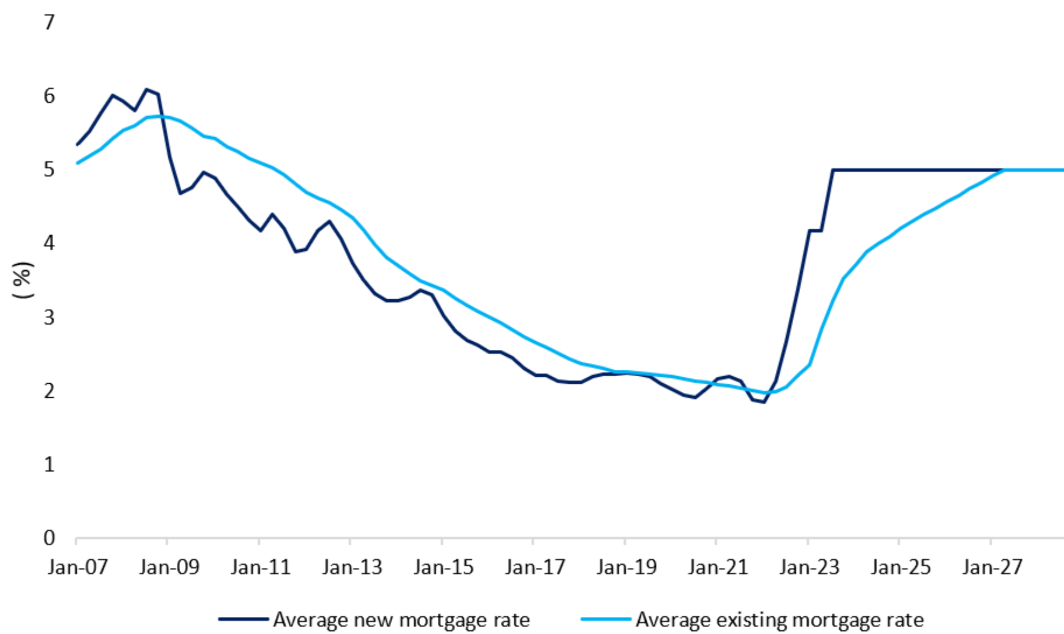


Source: Bloomberg, 30 June 2023

The work also tested for historic lags from policy tightening to labour market impact. As one might expect, the lags here are slightly longer as firms tend to react to a worse economic environment by cutting staff. Relationships here point to peak labour market impact occurring in Q1/Q2 2024 in the US and UK, and Q4 2024 in the eurozone.

Unsurprisingly, these relationships are not consistent over time given that at any one point any number of other factors impact GDP growth and labour markets, in addition to policy rate changes. For example, in the UK mortgages are logically a key transmission mechanism from higher policy rates to reduced economic activity. However, trends in the structure of this market point to a change in the pass-through rate of monetary policy tightening. The proportion of UK mortgages agreed with floating rates in 2012 was more than 70%; in Q1 this year it was 12.5%. As such, any policy tightening from the BoE that would have immediately reduced disposable income for a higher proportion of households in 2012 now does so to a much smaller proportion of households. While the full effect of higher rates will be felt across all mortgage-bound households eventually, it will take years to feed through – around half of all mortgages taken out in 2021 were done so on a five-year fixed term. Indeed, assuming rates remain where they were at the end of May, the average outstanding mortgage rate will likely only reach 4% in Q3 2024 (Figure 3). As a result, in the UK the model-implied peak GDP impact of rate hikes of October 2023 is likely to come later than history would suggest.

Figure 3: new versus existing UK mortgage rates



Source: ONS and Bank of England, 31 March 2023

While precise timing around when the full effect of policy tightening is felt remains uncertain, we are confident that from here economic activity will continue to feel the drag of already-implemented policy tightening to a greater extent. In-line with this, we continue to structure our Multi-asset portfolios with increased government bond duration allocations, and slightly reduced equity allocations.

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