Home > Insights > Market views

Market View
Central banks' data dependency and market volatility

Date 13 September 2024

Author Jeremy Sterngold

At a glance

- Investors are focused on whether the Federal Reserve will cut rates by 0.25% or 0.50% next week, amidst cooling labour markets and moderating inflation.
- Central banks’ communication strategies shifting from forward guidance to data dependency has increased market volatility and made forward planning more challenging, as central banks now rely on the latest economic data.
- With the US labour market slowing and the ECB also adopting a data-dependent approach, central banks are prioritising flexibility over predictability, impacting market stability and investor confidence.

The immediate question playing on investors’ minds is whether the much-anticipated Federal Reserve (Fed) rate cut next week will be 0.25% or 0.50%. Beyond this, debate is swirling around how swift the rate cutting cycle will be, given that the data we have seen out of the US shows labour markets cooling and inflation moderating, although it remains somewhat above target.

This week, we want to spend some time dissecting the different ways central banks communicate their intentions.

Forward guidance

One method is forward guidance, when central banks provide comments about the likely future path of interest rates and bond purchases. This communication method aims to influence investor, business and consumer expectations about upcoming economic conditions, allowing them to make longer-term financial decisions. Central banks will either commit to keeping rates low until a specific date or when specific economic conditions are met, such as when inflation hits 2%, for example.

In the previous decade, central banks relied a great deal on forward guidance. When interest rates were low, they used language as a key policy tool to guide markets about future interest rate policy, complemented by their asset purchase programs.

Data dependency

The other communication method is data dependency, when central banks base their policy decisions on the most recent economic data, such as inflation rates, employment figures and GDP growth. This approach gives central banks more flexibility and allows them to be responsive to changing economic conditions. They can tweak their policies as needed to achieve their goals, such as price stability and full employment. Rather than provide a clear specific path, central banks communicate their decision depending on incoming data, which makes policy changes based on economic developments more likely.

Having spent the previous decade relying on forward guidance, central banks had less room to manoeuvre and respond when inflation surged. Central banks therefore shifted towards data dependency as they were behind the curve in raising interest rates given their overreliance on historic models.

Market volatility

Abandoning forward guidance in favour of data dependency has clear drawbacks. Forward planning becomes more difficult, and markets become increasingly more volatile as they try to anticipate central bank responses with every data point. This has resulted in increased volatility in bond and equity markets, as the past few weeks have shown.

It is understandable why central banks shifted their communication approach to data dependency with uncertainties around inflation. Investors will remember how often Fed Chairman, Jerome Powell, kept insisting this inflationary period was transitory –it seems central banks had too much confidence in their ability to predict the path of inflation.

We are now witnessing signs the US labour market is slowing. Not knowing the extent of this slowdown has caused concern among investors, volatility in markets, and questions about the size of the first rate cut, as well as the level and speed of this looming rate cutting cycle.

ECB cuts rates

The US central bank is not alone in adopting this approach. On Thursday, the European Central Bank (ECB) lowered the deposit rate by 0.25% to 3.5%, the second decline this year. However, they remained ambiguous about future rate cuts. ECB President Christine Lagarde noted they are "not pre-committing to a particular rate path", and reiterated how the ECB will continue to follow a data-dependent approach.[1]

For now, it appears central banks are comfortable with the volatility that comes with their approach as they favour flexibility. We will likely know within the next few months whether they regain enough confidence in their ability to steer the economy and markets, which would perhaps justify moving away from such a data-dependent approach. That would be a welcome development as a cooling global economy could benefit from central banks expressing confidence in their forecasts.

[1] ECB, https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240912~67cb23badb.en.html

This communication is provided for information purposes only The information presented herein provides a general update on market conditions and is not intended and should not be construed as an offer, invitation, solicitation or recommendation to buy or sell any specific investment or participate in any investment (or other) strategy The subject of the communication is not a regulated investment. Past performance is not an indication of future performance and the value of investments and the income derived from them may fluctuate and you may not receive back the amount you originally invest. Although this document has been prepared on the basis of information we believe to be reliable, LGT Wealth Management UK LLP gives no representation or warranty in relation to the accuracy or completeness of the information presented herein. The information presented herein does not provide sufficient information on which to make an informed investment decision. No liability is accepted whatsoever by LGT Wealth Management UK LLP, employees and associated companies for any direct or consequential loss arising from this document.

LGT Wealth Management UK LLP is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

Investors should be aware that past performance is not an indication of future performance, the value of investments and the income derived from them may fluctuate and you may not receive back the amount you originally invested.

LGT Wealth Management UK LLP is authorised and regulated by the Financial Conduct Authority (FCA). Registered in England and Wales: OC329392. Registered office: Fourteen Cornhill, London, EC3V 3NR.