Market View
Divergent paths: central banks' growing divide

Date 14 February 2025

Author Jeremy Sterngold

Reading time 5 minutes

At a glance

- Central banks have increasingly different approaches to interest rates.
- Opportunities may arise in fixed income markets.
- Fed likely to hold for a while after CPI overshoot.

Given that geopolitics has been the source of most headlines in recent weeks, central bank policy has fallen from the top spot, although remains a significant factor impacting markets. As four of the largest developed market central banks— the Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB) and Bank of Japan (BoJ)—have now held their first meetings of the year, it's important to revisit this topic, and this week, we take a closer look to discuss the divergence in their interest rate paths and what this may mean for markets this year.

Not in a hurry

After cutting rates by a total of 1% in 2024, the Fed held rates steady at their first meeting of 2025, with Chairman Jerome Powell saying the Fed is not "in a hurry" to lower rates as elevated price pressures reduce the need for further cuts.[1] His wait-and-see approach seemed justified with the release of the Consumer Price Index (CPI) data earlier this week, which measures the prices of goods and services, showing that overall headline price pressures increased by 3% in the last year, and core pressures (which excludes the more volatile food and energy) increased 3.3% compared to last year. Looking at shorter-term price momentum, the three-month annualised headline CPI rose to 4.5%, the highest since November 2022. This has pushed expectations for a Fed rate cut well into the fourth quarter, with markets now pricing in only one 0.25% cut this year.

This report comes as investors ponder the risks of rising inflation amid ongoing tariff concerns. Tariffs could raise input cost for businesses and reciprocal tariffs may exacerbate the impact further. This, combined with fiscal policy ambiguity, prompted Atlanta Fed President Raphael Bostic to note "it's going to be impossible to make a judgement about where our policy should go".[2] This suggests a long pause in the Fed's rate cutting cycle this year unless the data warrants more immediate action.

A thorny UK landscape

The outlook for the UK is more complicated. The much-anticipated Labour budget in 2024, which included an increase in employer national insurance contributions, is likely to prove inflationary in the long term as businesses attempt to pass higher costs onto consumers.

In their first meeting of the year, the BoE cut interest rates for the third time in six months, sticking with their 0.25% cut per quarter pace. The bank's nine-member Monetary Policy Committee voted 7-2 in favour of lowering borrowing costs by 0.25% to 4.5% from 4.75%. Catherine Mann, previously one of the most hawkish members of the Monetary Policy Committee, turned dovish and joined Swati Dhingra voting for a 0.50% cut, an effort to ease

financial conditions which would allow for mortgage rates to fall further.

At the meeting, the BoE halved their 2025 growth forecast to 0.75% as the economy edges closer to stagflation but upgraded its growth forecasts for 2026 and 2027 to 1.5%.[3] It anticipates inflation will rise to 3.7% in the third quarter, a far cry from its 2% target. They cited higher energy prices and less favourable base effects as driving the overshoot before estimating a gradual fall back towards target over coming years. They also noted that Chancellor Rachel Reeves's decision to raise national insurance contributions would hit both jobs and prices more than expected, with the unemployment rate forecasted to rise to 4.8% over the next two years.[4]

ECB cuts as expected

The ECB cut rates in January and is expected to cut rates further in March as Eurozone growth remains weak. It was the fifth ECB rate cut since June 2024, and markets expect two or three more this year to bring the base rate closer to 2% as concerns over a lack of growth take centre stage with inflation close to target. Still, there is a degree of uncertainty for ECB President Christine Lagarde and members over how potential tariffs would impact the bloc. Recent developments towards resolving the war in Ukraine may reduce uncertainty in the region and result in better growth prospects this year.

Japan's latest rate hike

Japan meanwhile is embarking on its own journey. The country has been plagued by a deflation but more recently Japan has seen the return of inflation and wage growth. This led the BoJ to raise interest rates by a quarter point to 0.50% at its January meeting, the highest level since 2008 and the third hike in just under a year.[5] The yen strengthened on the back of the BoJ hikes. Japan also faces uncertainty about the tariffs, as it could be dragged into a trade war given its supply chains with Mexico.

Conclusion

The divergence between central banks is likely to widen this year. In the US, the base effects of inflation are fading, meaning the direction of prices over the next few quarters are key. Furthermore, uncertainty over the tariffs' impact on inflation and its global ramifications mean the Fed will not be in a hurry to lower rates. Powell may say the labour market is not a source of inflation and rates are restrictive enough, but it is highly possible he is waiting for more clarity about how Trump's policies effect inflation.

Since the bond market expects only a modest amount of rate cuts, there is some value in holding government bonds. However, ongoing fiscal concerns and tariffs may mean bond yields remain range-bound until we get further clarity.

[1] New York Times: https://www.nytimes.com/2025/01/29/business/economy/federal-reserve-what-to-watch.html

[2] Bloomberg

[3] Bank of England: https://www.bankofengland.co.uk/monetary-policy-report/2025/february-2025

[4] Times: https://www.thetimes.com/article/72f2ab14-31ac-4ce5-b302-3f7287811145?shareToken=b338a7cfdbe7ce391e7d5d8205b3966a

[5] New York Times: https://www.nytimes.com/2025/01/23/business/bank-of-japan-interest-rates.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.