Economic Weekly

How Central Is Banking?

June 10, 2024

Highlights

- BOC and ECB cut rates.
- US economy firm but slowing.
- Inflation still cooling.
- Fed set to hold.
- Global CRE markets could diverge.

After last week's broader international perspective, we are doing something similar once again. This week we focus on central banking given some noteworthy events from last week. The world has finally arrived at the point where monetary policy is shifting as central banks begin to cut rates and ease monetary conditions. But key central banks are not moving at the same time or the same pace. What does that mean for their respective economies and commercial real estate (CRE) markets?

International Inferences

Last week brought the long-awaited commencement of monetary easing among the group that (arguably) constitutes the world's most important central banks. The group of seven (G7) – the US, Germany, Japan, the UK, France, Italy, and Canada - represent the 7 largest developed economies in the world. Their respective central banks – the US Federal Reserve (Fed), the European Central Bank (ECB), the Bank of Japan (BOJ), the Bank of England (BOE), and the Bank of Canada (BOC) – together largely dictate what could be called global monetary policy. Their combined share of currency reserves equals roughly 92% of the global total. Most, if not all, of the members of this group will ease policy rates over the next 12 months. The BOC and the ECB took the lead here, cutting rates on consecutive days last week, both by 25 basis points (bps). And with the large drop in inflation in the UK in April (down 90 bps on a yearly basis), the BOE looks set to cut as soon as its next meeting on June 20. The BOJ will likely remain an outlier among this group with the potential to raise rates later this year because inflation is still running a bit hot, at least by Japanese standards. But what about Fed policy against such a global backdrop?

Domestic Developments

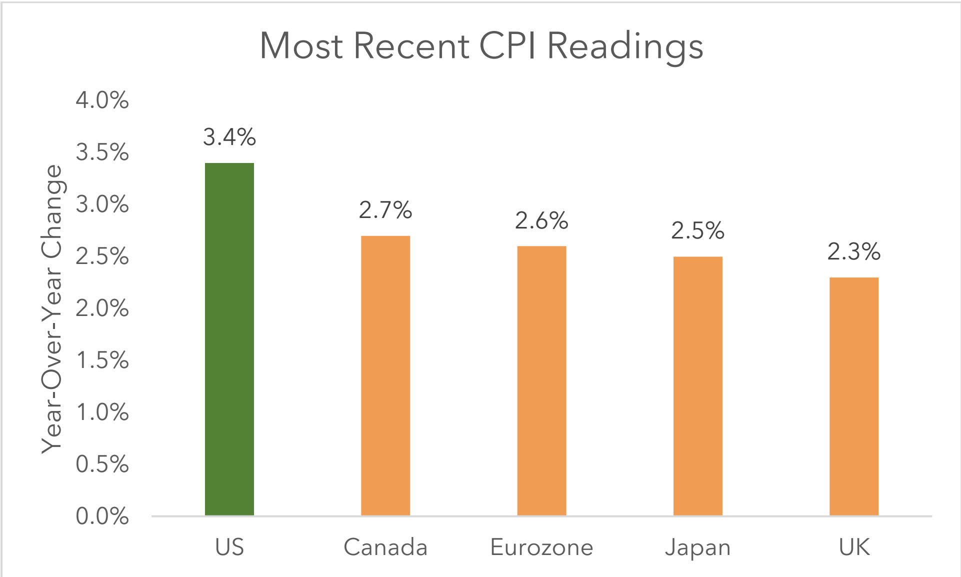
The domestic economic situation is clouding the Fed's decision making, even though we have long argued that it shouldn't. Last week's data, predominantly from the labor market, showed that while the US economic expansion remains rather durable, it is slowing. The data last week came in decidedly mixed – job growth exceeded expectations, but the unemployment rate ticked up again, wage pressures remained firm, and open jobs declined to their lowest level in roughly 3 years. Meanwhile, supporting data from the ISM services and manufacturing indexes showed the economy continued to expand but at the same uneven pace of recent quarters. But if we step back and take a broader perspective, economic slowing becomes clearer. The unemployment rate has increased by 60 bps since last year and real wage growth, while positive, isn't meaningfully accelerating any longer. Net job gains predominantly stem from immigration, which remains tenuous at the best of times. And GDP growth and consumer spending have clearly downshifted this year.

This week we will get the bulk of May's inflation data, which remains paramount for Fed policy. We anticipate deceleration in the consumer price index (CPI), producer price index (PPI), and import prices, largely due to the pullback in energy prices. Core inflation could still see some lingering pressure from shelter costs. And the preliminary reading on consumer sentiment for June seems likely to have increased following some tepid readings in recent months.

Fed Fumblings

Yet none of this data should be enough to move the Fed yet. Even with other major central banks shifting into an easing stance, we anticipate that the Fed will leave rates unchanged when it meets this week. Why? Because as we have vociferously argued, the Fed remains fixated on inflation measures that are lagged at best and incorrect at worst. This stems from the outsized share of rent in US inflation indexes, relative to those of other G7 nations, specifically because of the inclusion of owned-housing "rent." No other G7 nation uses such a metric, even when they attempt to measure the cost of owning a home. Housing remains expensive almost everywhere in the developed world because of an acute housing shortage. In some G7 countries housing is more expensive and is appreciating faster than in the US. Yet, only in the US is expensive housing skewing inflation data.

We need not relitigate our case against including such a measure in this weekly – previous publications of ours have already done so thoroughly. But the Fed is increasingly risking a downturn in the economy by leaving rates too high for too long because of this issue. In the US, inflation excluding shelter sits near Fed target. Or alternatively, the harmonized CPI, which effectively replicates the Eurozone's CPI basket, also rests very near Fed target. Both demonstrate that the Fed *could* currently possess the same rationale to cut rates as other major G7 central banks. While our modeling still suggests that the Fed could cut later this year, it does not have infinite time on its hands, especially as we see more evidence of slowing in the US economy. But letting other central banks cut first affords it the ability to watch and see what happens, which could provide it with more evidence and greater confidence to cut rates later this year.



CRE Implications

While one or two rate cuts have little direct impact on CRE markets, they indirectly can contribute notably. How? First, *ceteris paribus*, interest rate cuts help to stimulate the economy, support

space market fundamentals, and consequently boost income returns and valuations. Second, while limited rate cuts have little impact on CRE discount rates and cap rates via the reduction in the risk-free-rate (RFR) proxy, they historically have a much larger impact on the pure risk premia embedded in CRE discount and cap rates. As central banks start cutting interest rates, CRE valuations and appreciation returns increase, rather rapidly, as investors adjust their risk-reward preferences. Therefore, in the short run, CRE markets with declining interest rates (namely Canada, the UK, and the Eurozone) could see a quicker boost to returns as investor sentiment shifts. The US market will likely lag while waiting for the Fed.

Thought Of The Week

World leaders, including the pope, will meet at the G7 summit in Italy beginning on Thursday.

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