While long-term inflation expectations in recent years have been pointing to levels well below 2%, in recent months they have risen to around the target. A first rally occurred last summer when the ECB adjusted its strategy and implied that it would be somewhat more permissive on inflation. And in recent weeks, there has been another rally triggered by the conflict in Ukraine, which, beyond the short-term impact on energy prices, is expected to contribute to rising core inflation in the medium term.

Still, the war in Ukraine is a shock that is generating a great deal of uncertainty in relation to the economy, as well as in relation to the response from the ECB. While the conflict is fuelling inflationary pressures, especially in the short term, it could also weaken economic activity and adversely affect inflation in the medium term. In this uncertain context, the ECB is likely to decide to exercise caution and, even if it stops net asset purchases under the APP in the second half of the year, it will not necessarily introduce the first rate hike as early as the financial markets are currently suggesting.

Fed: balancing the need to cool the economy without triggering a recession

The Fed, on the other hand, is expected to pursue a rate hike cycle amounting to at least 1.75 pps over the course of this year and bringing interest rates into restrictive territory in 2023 and 2024 (above 2.4%, the level which the median voter on the FOMC considers to be the long-term equilibrium rate). In doing so, it is seeking to restore price stability without necessarily dragging the US economy into a recession. Finding the balance to avoid a recession will be a daunting task for FOMC members.

To assess the probability that the financial markets attach to a recession in the coming years, we usually look at the spread between the interest rate on 10-year sovereign debt and on other shorter maturities. Normally best spread to predict recessions in the next 12 months is that between 3-month debt and 10-year debt, and this is not currently showing any indications of a looming recession.[3] However, the spread between 2- and 10-year debt is already very narrow (and has even momentarily inverted). This suggests that the financial markets may now be assigning a higher probability to a recession occurring in the coming years, driven, for instance, by an aggressive tightening of monetary policy by the Fed. So, despite Jerome Powell's firm decision to raise interest rates – even with some 0.50-pp rate hikes – we believe that the Fed will not be able to ignore these indicators and will have to tread carefully, especially if inflation moderates towards levels closer to 2% in early 2023 as we expect.

3. The rate on 3-month debt is closely tied to the official Fed rate, and that rate is still very close to 0%, while the 10-year rate is around 2.5%. For further details, see «On the likelihood of a recession in the US» in the MR05/2018.

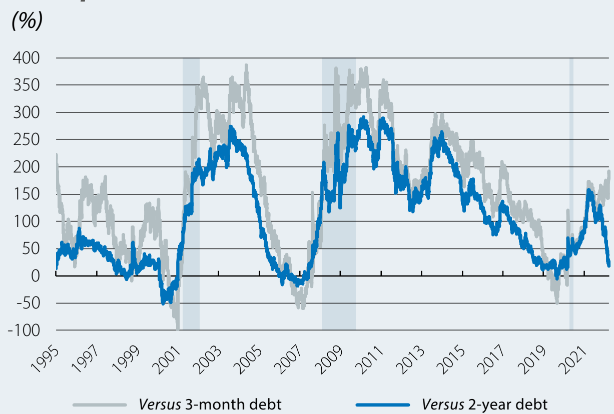
Federal Reserve: expected evolution of interest rates

(%)

Notes: *Each point represents a voter of the Federal Open Market Committee. The median voter is shown in black.*
Source: *CaixaBank Research, based on data from the Federal Reserve.*

US: 10-year sovereign debt interest rate spread

(%)



Note: *The grey shaded areas denote the periods of economic recession, according to the NBER.*
Source: *CaixaBank Research, based on data from Bloomberg.*

What is clear, however, is that in an environment of high geopolitical uncertainty, commodity price volatility and production bottlenecks, the central banks will need to have plenty of flexibility in order to respond to ever-changing needs.

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