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Central banks, inflation, and the case for quality bonds

Investment strategy insights

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- We expect most central banks across developed markets—including the Federal Reserve, Bank of England, and others—to keep rates unchanged in the near term. The European Central Bank stands out with likely rate hikes in June and possibly July, reflecting diverging policy responses to inflation and growth dynamics.
- Despite persistent inflation concerns and tighter financial conditions globally, evidence of second-round inflation effects remains limited. Meanwhile, labor markets are softening, suggesting the case for maintaining restrictive monetary policy indefinitely is weak across regions.
- For investors, the current environment supports a preference for quality bonds with short to medium duration, as elevated yields offer attractive income and the prospect of capital gains if central banks pivot toward easing in response to slowing growth and fading inflation pressures.

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With the next round of central bank meetings approaching, investors' attention is firmly fixed on the European Central Bank (ECB), which convenes on 11 June. While the Federal Reserve, the Swiss National Bank (SNB), the Bank of England (BoE), Norway's Norges Bank, and Sweden's Riksbank are all expected to keep interest rates unchanged, the consensus is that the ECB will raise its deposit rate by 25 basis points. In our view, a hike in June is highly likely and will probably be followed by a further increase in July, although conviction in the timing of the second move is low. It could easily slip to September or be skipped altogether, depending on how economic data evolve and how long the conflict in the Middle East persists. For June, however, the window for news that might prompt the ECB to pause is closing rapidly.

The rationale for the ECB's hawkish stance lies in its sole mandate to target inflation, in contrast to the Fed, which considers both growth and inflation when setting interest rates. With prices rising again in the Eurozone, ECB policymakers are understandably cautious. They are well aware that any action now will not prevent the immediate jump in prices, which remains largely confined to energy and transportation costs. Their real concern is the risk of second-round effects—whereby firms outside the sectors directly affected by rising energy costs increase their own prices, which could prompt greater wage demands and embed higher inflation into the economy. So far, there is little evidence of this dynamic taking hold, a point acknowledged in the minutes of the April meeting, though many on the Governing Council believe the risk is rising. The dilemma is that by the time official data confirm such effects, it may be too late to act pre-emptively.

Markets have already priced in rate hikes, so the immediate reaction to a June move from the ECB is likely to be muted. In fact, a greater response may come if the ECB opts to

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wait. What matters more is not the path for rates over the next few months, but where expectations sit a year from now. While near-term hikes are reasonable, the notion that rates will remain at 2.5% for a prolonged period is less convincing. Growth is slowing, real incomes remain under pressure, and labor markets are softening. It is difficult to justify keeping policy at restrictive levels indefinitely.

This observation applies to other central banks as well. Forward rates suggest monetary policy will be tighter in the US and the UK a year from now, something we do not believe is particularly likely, given the greater evidence of labor markets softening and fading wage pressures already seen in the Eurozone.

For investors, this environment presents opportunities. We continue to see value in quality bonds, particularly those with short to medium duration. Yields have already repriced higher, allowing investors to lock in attractive income. Should growth disappoint, bonds should benefit as central banks eventually move to cut rates.

In conclusion, while some near-term monetary policy tightening in the Eurozone appears likely, the case for rates remaining elevated indefinitely is weak. The prudent approach is to take advantage of current yields, focus on quality, and remain alert for a shift in central bank rhetoric as growth concerns come to the fore.

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Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities
Note: For equities, we have a five-tier rating system with two additional preferences
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Appendix

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