An inconvenient truth for central banks

The recent surge in long-term interest rates in both the US and the eurozone illustrates an inconvenient truth for central bankers: as soon as financial markets start believing that rate cuts aren't coming anytime soon, market movements could push economies and policy rates in very unpleasant directions.

Watch: The 'inconvenient truth' for central banks

Are central bankers bluffing when they say interest rates could go higher still? The markets seem to think so. And if that's the case, there could be some nasty surprises around the corner.

Watch video

Longer-term interest rates are key now

It takes a while before higher policy interest rates find their way into the real economy. Some central bankers have openly discussed that this time around, the transmission of monetary policy is faster and stronger than in the past. This, however, does not diminish the evidence that longer-term interest rates have an even stronger impact on the economy than policy interest rates. According to standard models, at least in the eurozone, an increase in longer-term interest rates has a four times stronger impact on growth than a similar-sized policy rate hike.

Therefore, looking at interest rate movements in both the US and the eurozone explains why the negative impact of central banks' actions has so far been limited. In the eurozone, 450bp ECB rate hikes only pushed up 10-year German bund yields by 150bp, at least until the September ECB meeting. In the US, the Fed hiked interest rates by 525bp, pushing up 10-year US bond yields by 250bp, again until the Fed's September meeting.

Over the last two weeks, bond yields in the eurozone and the US surged by some 50bp. If standard econometric models are still of any guidance, the recent surge in bond yields alone should already have the same impact on economic activity as half of the policy rate hikes so far.

There are several reasons for the latest surge in bond yields. Just think of the recent increase in oil prices and fears that inflation might be stickier than hoped. But think also of renewed debt sustainability issues in both the US and the eurozone. Finally, the enormous efforts by central bankers to convey the message that rates will be high for a long while and a potentially earlier unwinding of the ECB's asset purchases have also played a role.

At first glance, central bankers should be happy looking at their screens as far as market interest rates are concerned. Financial markets are finally waking up to the scenario of 'higher for longer'.

In our base case scenario, it is still a 'high' and not 'higher' for longer, as we expect at least the Fed and the European Central Bank to have already reached peak policy rates. However, just judging from official comments, the risk of further additional rate hikes remains high. Admittedly, this is not the forward-looking type of central banking that students are taught at university.

Looking more closely, however, central bankers should be more concerned that financial markets are finally getting familiar with the 'high for longer' scenario. The increase in longer-term interest rates has the potential to push both the US and the eurozone economies not only into recession but also to break something somewhere. The irony of such a scenario would be that the more financial markets believe in 'high for longer', the higher the chances are that central banks will actually cut rates.

It's a very inconvenient truth for central bankers.

Our key calls this month

- **Oil:** The market saw significant strength over the third quarter, with the market set to remain in a deep deficit until the end of the year. This tightness suggests we could see more upside, but we believe any move above $100/bbl will be short-lived
- **United States:** The US economy has performed strongly, with the Federal Reserve and financial markets both re-evaluating the likely path for interest rates. But sharply higher borrowing costs will increase financial stresses in the economy and mean recession fears will linger. A possible government shutdown in November adds an extra reason for the Fed to proceed cautiously later this year. Expect the first rate cuts in the spring.
- **Eurozone:** While a full-blown recession might still be averted, 2024 growth is likely to be lower than this year. Inflation is declining slowly, but with the European Central Bank taking no risks, a first rate cut is unlikely before the third quarter of 2024.
- **China:** While China's economy is still struggling, it is at least not getting incrementally worse and there are some pockets of improvement. The government remains focused on targeted market support rather than a one-size-fits-all fiscal boost.

- **United Kingdom:** Investors have significantly reappraised the Bank of England outlook over recent weeks, and we think rate hikes have now finished. Rate cuts are likely to be a story for next summer.
- **Central and Eastern Europe:** Inflation continues to fall rapidly in the CEE region, while economic numbers are surprising on the negative side. At the same time, we see signs of a turnaround in the third quarter in some countries. Monetary policy is moving toward rate cuts, while fiscal policy tries in vain to tighten.
- **FX:** Resilient US growth, a hawkish Federal Reserve, and misfiring overseas economies are driving the dollar higher for a third straight month. We are deferring our call for a dollar sell-off this year, but three-quarters of negative US growth and 200bp of Fed easing should finally deliver a dollar reversal.
- **Market rates:** The US 10-year has got 5% on its mind, while the 10-year Bund yield is knocking on the door of 3%, and can stretch towards 3.25%. The 10-year Euribor rate at around 3.5% still maps a negative real yield when measured against the latest inflation print. Enough there for market rates to continue to test higher.

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