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# Rates: here's why rates need to rise again before falling

Market rates are primed for a large fall. But first, we need to see hints of a peak in official rates, and that still depends on a very uncertain path for (core) inflation. Once that is in, or we are much closer to it, we can prepare for a structural decline in market rates

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## Significant volatility as we approach end game for hikes but terminal rates still unknown

It's been quite the ride over the past few weeks, and there is little to suggest that things will get materially calmer in the months ahead.

The move at the long end of the gilt curve was nothing short of spectacular, with the 30-year yield rising from 4% to 5% in the space of two days in response to the government's proposed tax cuts. It correlated with the US 10-year yield briefly breaching 4%, and the eurozone 10-year swap rate hitting 3.3%.

All of these levels are significant: 5%, 4% and a breach above 3.25% for long tenor market rates in the UK, US and eurozone. The last time we saw such levels was in the 2010/11 period, as the euro sovereign debt crisis was developing. And only a few years before that, on the eve of the Great

Financial Crisis, the UK Bank rate and the Fed funds rate were in the area of 5%, and the European Central Bank's refi rate was in the area of 4%.

*The delta between current official rates and terminal ones has shrunk*

Fast forward to today and the current market discount sees the UK Bank rate getting to 5.5%, the Fed funds rate to 4.5% and the ECB refi rate to 2.75%. The delta between where official rates are now and where they are expected to get to remains large, at more than 3% in the UK, 1.25% in the US and 1.5% in the eurozone.

That said, large chunks will be taken out of those in the next few weeks, as expected hikes are 1% from the UK and 75bp apiece from the Federal Reserve and the ECB. Those are close enough to be broadly nailed on. After that, the delta from official rate levels to likely terminal rates shrinks to 2.25% in the UK, 50bp in the US and 75bp in the eurozone. That's quite close to the peak, if those are in fact the peak. And that remains a key unknown.

## If market rates fall further, that will frustrate the purpose of central banks. So in the end, they rise

Apart from the UK, which is paying a future rate premium for the fiscal loosening, the market discount for the Fed and ECB senses an end game for hikes. Disentangling this move from the Bank of England's intervention is important. We do that by focusing on financial conditions in the US and eurozone, and we find that on the Bloomberg measure they are very tight right now.

That does suggest that central banks can begin to ease off, and in fact, justifies the fall in market rates seen in the past week or so. The issue, however, is whether those implied terminal rates will be realised. We will only know the answer when we get there.

*Market rates should not anticipate a peak in official rates in an overly premature fashion*

Market rates should not anticipate a peak in official rates in an overly premature fashion. For two reasons:

1. We can't say with certainty that core inflation pressures have turned lower in a material enough fashion, and central banks will want to sustain tight financial conditions until we are at a point where those core inflation pressures have actually eased.
2. Any material fall in market rates will loosen financial conditions, potentially causing central banks to then double down with sustained hawkish rhetoric, in turn requiring a re-elevation in terminal rate expectations, and pulling market rates back up with them.

The counter argument is we are at a tipping point here. Some of the survey evidence helps to support this stance but most of the labour market data does not. And wage inflation is a key ingredient when it comes to second-round inflation effects.

## There is a big fall in market rates to come, but not till the Fed is much closer to being done

Market rates are on a declining trend currently, partly as they have been shocked there by the Bank of England's move, but also as that is what tends to happen when official rates approach a peak. We agree that market rates are primed for a large fall. But we need to see hints of a peak in official rates first, and that still depends on a very uncertain path for (core) inflation ahead. Once that is in, or we are much closer to it, we can prepare for a structural fall in market rates.

In consequence, we feel that any material fall in market rates from here will subsequently need to be reversed higher. We might not quite get back to a 5% handle on the UK 30-year gilt yield, but don't be too surprised to see a 4% 10-year Treasury yield again in the weeks ahead. And in the eurozone, the German 10-year back above 2% and the 10-year swap rate above 3%, are all entirely possible.

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