

Rates: Here's why there are upside risks despite cuts

Usually, rate cuts are good for bonds. As the ECB cuts, there is certainly a bond bullish tint to the move. However, the outlook is clouded by a lack of clarity on the extent of ECB cuts ahead – and a Fed that remains constrained by inflation data. We also find that real yields remain quite low (vs printed inflation), limiting the capacity for a rally in bonds



A key difference between the eurozone and the US is that the European Central Bank has delivered a rate cut

Rate cutting is an important signal for bonds, telegraphing good things for returns

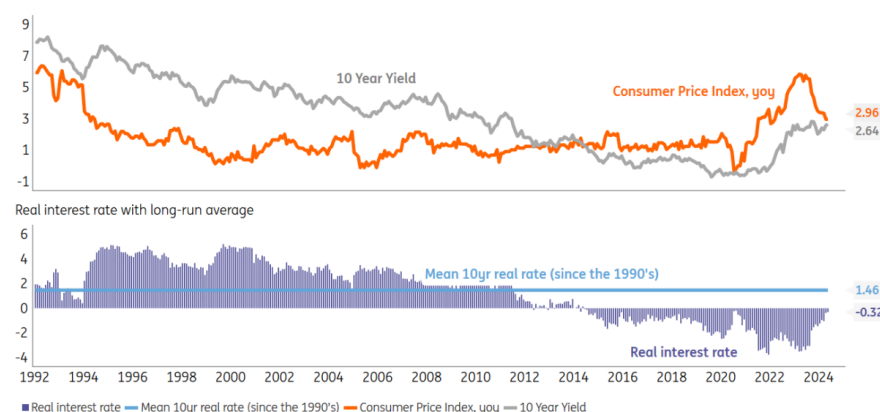
One key theme running through our analysis is the notion that the past decade and a half was not a normal period from which to reference the immediate future. We had the global financial crisis, a European sovereign debt crisis and the pandemic during this period. All of these placed material downward pressure on policy rates and on bond yields. Bad things could, of course, happen again in the future (and likely will), and this remains a rationale for having a diversified portfolio that includes a decent exposure to bonds. However, from a relative value perspective, that's not enough to justify material falls in yields, at least not given what we know.

In the past week we sent out a piece that argues 4.5% as an equilibrium area for the [US 10yr yield](#). It's not far from where we are now. We then argue that 5% is a level we can trend towards,

given the stickiness of inflation and persistent supply pressure. To change that dynamic we'd need to see interest rate cuts from the Federal Reserve, as history shows that initiation of rate cuts typically coincides with material downward pressure on bond yields. That can in fact bring the 10yr yield to the 4% area.

But if there are no cuts in 2024 (not our view), there is also little prospect for the 10yr yield to fall in a material manner. Moreover, with real yields so low, inflation easing lower is not enough to justify lower yields. Only Fed cuts (or the hard discount thereof) can prompt material falls in the 10yr yield – and that, of course, requires lower US inflation as a precursor.

Real Rates are still quite low. So falls in inflation do not imply falls in bond yields with certainty...



Source: ING estimates, Macrobond

The chart above argues something similar for the eurozone. There are many real yields to choose from, including the obvious one – the eurozone real yield. But the chart has a German focus, purposely. It shows that the 10yr real yield remains exceptionally low relative to history. In a very similar manner to the US, there is a comfortable spread of some 1% between the real yield today and its long-run average. There are two ways for the real yield to rise. The most obvious one is for inflation to (continue to) fall. The other is for bond yields to rise. And one does not imply the other. In other words, falls in eurozone inflation do not translate directly to falls in yields, at least not without more.

ECB cuts are constrained by a Fed that remains on hold, and by low real bond yields

A key difference between the eurozone and the US is that the European Central Bank has delivered a rate cut, and by definition has peaked for this cycle. The Fed likely has peaked too, but the outlook is a tad more nuanced. There is a definite Fed rate cut discount, but the timing of delivery is more opaque. That places something of a brake on capacity for eurozone yields to materially fall.

But that also reflects a very complex prognosis for what happens next. Usually a first cut is followed by more cuts. That's likely the same here – although there is an ongoing lively debate on this. Bottom line, an ECB cut is big. But, unusually, it does not telegraph a convincing bond bull

market message.

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