

Padhraic Garvey: Lower rates by the end of 2023, but there are risks

We previously forecast market rates to fall, curves to steepen and US rates to converge on eurozone ones. The biggest risk is sticky inflation, higher market rates, and then something breaks. That, in turn, requires lower rates than we had anticipated in the medium term. We also face budgetary, supply, and geopolitical risks and so much more



Our view sees market rates lower, steeper curves and US convergence to the eurozone

Our call for 2023 previously centred on the notion that the US 10yr Treasury yield would fall from 4% to 3%, and by the end of 2023, the curve would be in the middle of a pronounced re-steepening process. Eurozone yields would follow US yields lower, but not by as much. And with the European Central Bank keeping rates at their peak while the Fed commences cutting, eurozone rates would converge on US market rates, in fact trading through US market rates as the Fed's cuts begin to look quite at variance to an ECB still very much on hold as we approach the end of 2023.

We also laid out the notion that the US 10yr would, in effect, map out a range from 4% to 3% (maybe briefly below) and then back up toward 4% by 2024. The latter reflects the view that the Fed bottoming at slightly below 3% in 2024 should coincide with the 10yr yield being forced back up toward 4%, as in this way an upward sloping curve would evolve, as has been typical in previous cycles. The eurozone curve would echo many of these trends, just with a lag, just as the ECB tends to lag the Federal Reserve.

But, sticky inflation and persistent demand could push market rates

So what are the risks to this view? Well, one is inflation failing to calm. This would keep official rates both in the US and the eurozone higher than we anticipate and, by extension, would frustrate the likelihood for market rates to test lower by as much as we forecast. Rather than the US 10yr heading to 3%, it, in fact, breaks back above 4% and heads for 5%, or even higher. If this did happen, it would most likely come from the Fed forcing market rates up there through a combination of higher official rates and more aggressive quantitative tightening.

It would also elevate the risk that something breaks, as here the Fed would have failed on the soft approach and has little choice but to keep policy on a super-tightening trajectory. The consequence of this would, more than likely, be bigger cuts in the future after something has actually broken. This augurs for the delivery of wider credit spreads as default risks elevate too, and for higher volatility, as both rates and spreads are more prone to bigger and more erratic swings.

Lower market rates in 2024 than anticipated is the risk case outcome

The bigger the need for even higher rates now, the bigger the likely fall on the other side. So, rather than the Fed stopping at a little below 3% on the rate-cutting side, the Fed might be seen to go to 2% or even lower. A return to zero rates would be quite an extreme outcome, but not impossible. It depends on what's been broken along the way and how mendable it is. The two focus areas here would be on the banks and defaults (in both the personal and corporate sectors).

That brings us to another extreme outcome that is deviant from our view, one where the Fed is actually done now, and the macroeconomy really begins to creak in the quarters ahead. Agreement for spending reductions could add to this downward spiral, and if the international dimension echoed these themes, there is a scenario where US and eurozone market rates, in fact, shoot well below our predicted floors. This is a less likely scenario based on what we have seen so far in 2023. It is more likely to get to this low rates scenario if we go through a higher rates one first.

There are other things that could go awry.

A bigger banking stress story could have the effect where both the US and eurozone economies stall abruptly, manifesting in much lower market rates. Here the convergence process is accelerated, as this would most likely be a US issue, at least to begin with.

A worsening in the war in Ukraine, with spillover to Western Europe, is a route for elevated stress in Europe over the US. That will put downward pressure on market rates through flight to safety.

There is also a counteracting supply story where spending pressures in both the US and Europe puts upward pressure on market rates.

Clearly, there are significant pushes and pulls, but based on what we know, the biggest risk is for stickier inflation than we forecast, and for that to frustrate expectations for rate cuts and associated turn-of-cycle falls in market rates, dis-inversion and the re-steepening of curves.

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