

The lure of rate cuts in 2024

Bond markets love nothing more than the turn of the rate cycle. That's why we're bullish and anticipate an evolution towards normal-looking upward curves at lower levels. It's all sounding just a bit too normal, though. We still worry about liquidity risks, the fiscal deficit in the US, and geopolitics – and admittedly, about 2024 as a whole



The lure of rate cuts is looming for the year ahead

The year ahead will be all about anticipation for rate cuts, and then delivery

Bond markets tend to get very excited when central banks gear up for rate cuts. So far, both the Federal Reserve and the European Central Bank (ECB) are doing their best to keep the rate hike narrative alive and well, but markets have concluded that they are done and that the next move is down. In fact, markets are discounting almost 100bp of cuts from both the Fed and the ECB in 2024. Once central banks start to cut, the discount for cumulative cuts tends to deepen further. At the beginning of the rate cut cycle, it's all about anticipation. Actual delivery is assumed, and market rates fall.

What happens to front end rates is obvious. If central banks cut, then 2yr yields will clearly gap lower. Typically, once the cuts are coming (about three months ahead), the 2yr jumps lower – often by as much as 100bp in a matter of days. The big question is what happens to longer

tenor rates. The answer is they usually fall, too, right out of the curve. In fact, total returns are typically maximised in the 30yr. There is a nagging fear that the US back end might struggle to perform due to fiscal pressures. But we are of the opinion that the bond market obsession with the rate cycle should dominate, causing a bullish steepening of the curve from the front end.

But, beware of waning liquidity...

And there are concerns about liquidity conditions to consider. We've been awash with liquidity since the pandemic, but both the Fed and the ECB are – in varying degrees – engaging in (soft) quantitative tightening. It's gone under the radar so far but will become an accelerated issue through 2024. It's unusual for liquidity to get tighter as central banks cut rates, but that's the juxtaposition we're facing.

Central banks need to be careful not to overdo the liquidity withdrawal, as there is a route to hurting the functioning of the system here. Separately, liquidity in US Treasuries has already become a worry, and both bank and market repo are not as influential as they once were in driving overall liquidity. Ideally, this theme should not be overly impactful, but is still a key area to keep an eye on in 2024.



Our key calls for rates in 2024

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The bullish steepening expected will also be impacted by other risks and prospects for 2025

Bond markets will also be keeping an eye on prospects for 2025, as they must, given they are long-tenor products. Here, the baseline market discount for both the Fed and the ECB in terms of lows for official rates is benign. In both cases, the end game is some 100bp short of where we anticipate official rates getting to. We think the 3% area is the neutral Fed funds rate and 2% to 2.5% is neutral for the eurozone, and we anticipate getting to these levels. That assumes a convergence on neutrality for 2025, with upward sloping 2/10yr curves stacked on top, or about 100bp in the US

and 50-75bp for the eurozone.

That discount can be impacted by many things, and the US supply story is one. By 2025, we could have a fresh administration to deal with following the US presidential elections, and how that administration deals with the deficit and geopolitics will be key. In the eurozone, the prognosis with respect to Russia and Ukraine – as well as future linkages with China – will be key, and their impact on Germany will be particularly important for the region's economy. There are also significant macro uncertainties to consider. We will know more as we progress through what is expected to be a difficult 2024 in terms of macro activity.

An uncomfortable call for a return to normality

Our baseline view is that we will land in a better place as we progress beyond 2024 and into 2025. We will still be in a rate-cutting phase, but we assume that both the Fed and the ECB get rates down to normal levels and to a point where they are neither contractionary nor stimulative. In many ways, it would be the completion of a return to normal process, following a decade and a half of a post-great financial crisis legacy and a pandemic-induced jump start to inflation. What makes us uncomfortable is this is all too balmy an outcome. Our conviction is centred on the lure of government bonds as official rates fall in 2024. After that, it gets much more fuzzy.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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