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Rates Spark: Already overshooting to the downside

What a week it's been. Central bank anticipation first. Then, evidence of a holiday party at the Fed. Followed by failed attempts from Frankfurt and London to poop that party. But there's no stopping this one. Everything is getting bought in a one-way market. We know we can't simply extrapolate the last few days endlessly. But leaving the party early is tough

Central banks are acting to diverge rates, but direction is one way and bullied by the US

Two things we can say about current price action.

First, it is clearly being directed from the US. The change of tone from Chair Powell after the FOMC was as dramatic as it could be against a backdrop where, in fact, a whole lot hasn't actually changed. Rate cuts in 2024 are, therefore, a go. At least there is no clear objection from the Fed. The question is when and by how much. We've been at 150bp of cuts in 2024 for some time, so no change here. We've noted before that the bond markets love cycle turns towards cuts, and we're getting a strong flavour of that.

Second, the ECB and the Bank of England are adopting a more traditionally hawkish stance. The implication of this for market rates has been a tightening in spreads. For example, the Treasury vs

Bund spread is tighter by some 20bp, and it's in by 30bp in the 2yr. But even with this tightening (US outperformance), both gilt yields and eurozone ones have been pulled lower. Had it not been for Chair Powell, it's highly unlikely that we'd have had the move lower in peripheral yields beyond the US over the course of this full week.

There is a global rate cutting narrative for 2024 acting to fuel falls in market rates too

It's not that the US is the be-all and end-all, as in fairness, there is a rate-cutting narrative in play on a global scale. A glance at any of the rate cut expectation functions on terminals shows that economies still hiking rates are in a clear minority. Across EMEA, it's all cut expectations, bar Morocco. In Latam, it is practically all cuts from the major markets (excluding the ultra-high-yielders). In Asia, it mostly cuts. Japan is the clearest exception.

The tone from the Fed helps to validate these wider rate cut ambitions. The dollar trade-weighted index has had a big move most from the FOMC, one of dollar weakness. A weaker US dollar and dollar rate cut expectations make rate cuts elsewhere that bit easier to engineer, whatever the individual domestic circumstances are. The remaining couple of weeks of 2023 are unlikely to see a change in mood. Lagarde and Bailey had a go, but it's clear the markets are hearing what they want to hear. Probably right too.

We think the 10yr yield is overshooting to the downside, but stay with it all the same

One thing to bear in mind, though, is the following. We think that 4% is long-run fair value for the US 10yr yield. It's now below 4%. So it's overshooting to the downside. This will continue. We think it can comfortably head to 3.5% in 2024. If it got to 3% it would be a significant overshoot, as we are anchored by an expectation that the Fed bottoms at 3% when it completes it's rate cutting cycle. And we want to see a fair value 100bp curve on top of that. Hence the fair value at 4% for the 10yr. Enjoy the overshoot while it lasts (and it will persist for a quarter or two). We're still bullish. But don't forget that it is an overshoot.

Today's events and market views

There is lots of US data today, but it's unlikely the market will pay too much attention unless they are dramatically different from consensus. Capacity utilisation remains quite elevated and is expected to remain so for November, in line with some recovery in manufacturing production from quite a weak October. A hot of PMIs will come in in the area of 50 or a tad lower. Most of these are, in fact, comfortably above prior lows. Remarkable, really, given the change of tone from Chair Powell this week. These are all largely second-tier in importance, so we'd have to deviate dramatically to have a material effect on markets. Still, it's another update. They are likely ones that leave us none the wiser, though.

The main focus in data should be the eurozone flash PMIs for December, which are seen to come in marginally better. This would be in line with the narrative of economic stabilisation, albeit at a low level. Another focus for bond markets is the announcement of the Dutch state's funding plans for 2024 in the afternoon.

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