# Rates Spark: Cuts are coming, just not that early

The FOMC and US refunding feature on Wednesday. The question on the refunding is whether the November estimates hold, or are morphed lower based on the adjustments published on Monday. From the FOMC we don't expect to the Fed to endorse March rate cut talk, but that's the big question to be answered, and more likely coming from the press conference. Big day...

## Expect an FOMC focus on technical adjustments, and less embrace of calls for early cuts

The dovish shift in Fed forecasts in December – with three rate cuts pencilled in for 2024 – incentivised the market to push even more aggressively in pricing cuts. However, they appear to have gone too far too fast for the Fed's liking, even though inflation is almost back to target. We expect that tome to come from the FOMC statement and Chair Powell's subsequent press confernce.

The Fed ignited an accelerated discussion on potential tapering of its quantitative tightening (QT) agenda. Currently the Fed is allowing some $95bn of bonds to roll off its balance sheet on a monthly basis. So far this has not pressured bank reserves, which are in the $3.5tn area. The Fed has been quoted as viewing this as comfortable, with the implication that they can fall, but not by too much. The 10% of GDP back-of-the-envelope target would be in the area of $3tn.

Most of the pressure from the QT programme is being felt through lower reverse repo balances going back to the Fed on the overnight basis. Ongoing balances there are running at around $550bn, down by some $1.8tn since March 2023. There are two sources of comfort here. First, room from the reverse repo balance of $550bn. That can get to zero without a material impact on bank reserves. Second, the fact that bank reserves themselves have a $500bn comfort factor between $3.5tn now to the $3tn area neutral.

It's likely the Fed formulates a plan to slow the pace of QT over the second half of the year, as by mid-year we expect to see the reverse repo balances pretty close to zero. Maybe cut it by a third for starters. We'd then be on a glide path over the second half of 2024 where bank reserves would begin to ease lower. We'd then expect QT to have concluded by year-end.

Ahead of the Fed we'll have the refunding estimates for the first quarter from the Treasurry. The question on the refunding is whether the November estimates hold, or are morphed lower based on the downward adjustments published on Monday. They don't have to be adjusted lower, as less bills issuance is also a target for the Treasury. Bills are still over 20% of total debt. They need to be closoer to 15%. So don't get hopes up too much on less coupon issuance pressure – that's likely to remains very elevated.

## EUR rate focus on country CPI estimates with rate-cut pricing still aggressive

The GDP figures from the eurozone came in at expectations or slightly above, but most remain in stagnation territory. Albeit the growth story is far from stellar, a severe recession scenario seems to have been averted for now. But the bearish tone was also set by the upside surprise in the Spanish inflation estimate for January alongside the robust GDP showing with Euro rate markets recording a slight uptick in yields across the curve. Nevertheless, rate cut expectations remain aggressively priced with a 90% probability of cuts by the April meeting.

On Wednesday, January inflation figures for Germany and France will be released, which will provide important insights into the overall price pressures in the eurozone. Consensus sees headline year-on-year figures around 3% but expects the month-on-month figures to come in well below the 2.0% target on an annualised basis. The European Central Bank has reiterated its data-dependent approach many times and therefore sub-target month-on-month inflation numbers will help markets maintain their conviction of an April rate cut.

Given the aggressive pricing already for 2-year yields, we do not see much potential for a further decline in yields if the low inflation expectations are indeed met. On the other hand, a month-to-month reading above target would shake rate expectations quite a bit and would signify a sharper upward move in 2-year yields. Given the recent correlation between short-end and long-end rates, the impact would be felt throughout the curve.

## Wednesday's events and market views

Besides the aforementioned inflation figures for Germany and France, we will also have unemployment rate data from Italy and Germany. Consensus expects the unemployment rate of Italy to stabilise around 7.5% and thus remain at the lowest level since 2009. The strong GDP figures from Italy released on Tuesday give little reason for concern that the unemployment rate would jump up. Weak growth in Germany warrants a more cautious

approach to the unemployment data.

In the US the highlight is of course the FOMC meeting. In data focus remains on labour indicators, albeit the ADP payrolls estimate usually has limited value in forecasting Friday's official jobs numbers. Greater attention could be paid to the employment cost index for the fourth quarter, especially since unlike the average hourly earnings it is not affected by composition changes in employment between low- and high-wage sectors.

Supply wise the the focus should be on the 15Y syndicated bond that was mandated by Italy. Regular auctions see Germany issuing €4.5bn in 10Y Bunds. Following up on Monday's lower-than-anticipated borrowing needs, the US Treasury will now make the quarterly refunding announcement, which should show another increase in coupon issuance along the lines of the November template.

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