

## Rates Spark: Does the Fed know something we don't?

The surprise from the FOMC was partly the extra 25bp implied cut added to 2024, but it was more the lack of pushback from Chair Powell on the 2024 rate cut narrative. He almost endorsed it, which leads us to question whether he knows something of significance that we don't. Today's focus is on the ECB and BoE policy meetings



### Chair Powell validates the move from 5% to 4% on the 10yr yield

Such was Federal Reserve Chair Jerome Powell's phraseology at the press conference that one must suspect that he knows more than we know. And its not about the macro data. We can see that. It's more about what the Fed might be seeing under the hood. Perhaps in commercial real estate, or single family residential rentals or private credit, or another other area of the system that might find itself overexposed to rate hikes delivered, under water and vulnerable to breaking. We don't know of course, but a Fed chair that stands up asserts that he understands the dangers they run by keeping rates too high for too long is one that looks like he's ringing alarm bells.

Along with the Fed, the market too has added an additional 25bp rate cut for 2024, now at 150bp

cumulative. The entire curve has shifted lower, led by real rates. The 2/10yr curve has gapped steeper too. This is a meaningful outcome. The question now is whether the 2yr can really break free and head lower as a driver of the yield curve, steepening it out from the front end. That traditionally happens on a three month run in ahead of an actual rate cut. We're on the cusp if this, but not quite there just yet.

It's been a remarkable ongoing market move, especially as it has been interlaced with some tailed auctions, indicative of resistance to the falling market rates narrative (in the long end). But there's been little from Chair Powell and the FOMC to stand in the way of this. Recent data has not really validated the dramatic fall in yields. But today the Fed has helped to do so. A far more hawkish Fed had been anticipated.

The question ahead is where is fair value for the 10yr. We think it's 4%. It's premised off the view that the funds rate gets to 3% and we are adding a 100bp curve to that. We are about to sail below 4% though as a theme for 2024, with 3.5% the target. But the move below 4% towards 3.5% will be an overshoot process. If something breaks, we fast track all of that and jump to a new environment. That has not happened as of yet, but we think the stakes have risen.

## ECB to push back against early cut expectations

With a first rate cut more than fully discounted by April and on overall anticipated easing of 135bp over 2024, the market's expectations of European Central Bank policy stand in stark contrast to the official line of rates having to remain high for longer. But since the last meeting in particular the inflation data has surprised to the downside, which even influential ECB officials like Isabel Schnabel had to acknowledge. The prospect of further hikes is clearly off the table, but she warned that central banks will have to be more cautious. That also meant that the ECB should be more careful with regards to making statements about what will happen in the next six months.

The ECB's new growth and inflation forecasts will have to be lowered, the crucial question is just by how much. Also taking it from Schnabel, the ECB is unlikely to give any longer rate guidance, which would only mean a truer meeting-by-meeting and data dependent approach.

Still, the ECB is unlikely to endorse the aggressive market pricing, especially that of cuts already early in the year. So far the communication has been that one is particularly concerned about the development of upcoming wage negotiations which makes pricing for March rate cuts look premature. But how can the ECB still convey a hawkish tilt? One possibility is using communication about plans to shrink the balance sheet. We do not think there will be concrete decisions yet, but the ECB could state that it has begun discussing to potentially end PEPP reinvestments earlier than planned.

## BoE likely reiterate rates will stay restrictive for an extended period

Expectations of policy easing have further deepened ahead of today's Bank of England monetary policy committee meeting. A first rate cut is now fully discounted by June with an overall expected easing of close to 100bp over 2024. One reason for growing expectations was a downside surprise in wage growth which saw private sector regular pay growth fall to 7.3% year-on-year from 7.8% YoY. Another trigger was yesterday's disappointing GDP growth for October which means we are potentially on track for a fractionally negative overall fourth quarter figure.

The BoE is likely to reiterate the guidance from November, where it said it expected rates to stay restrictive for “an extended period. A hold is also widely anticipated by the market, but the recent data could convince some of the three MPC’s hawks who had still voted for a hike in November to back down from that position toward a ‘no change’.

## Today’s events and market view

The central bank meetings are clearly the focus today given how far market expectations of policy easing have come. There may well be some disappointment in store for pricing of rate cuts as early as March. But further out we must acknowledge that the shift lower in rates is also driven by a drop in inflation expectations. The 10Y EUR inflation swap for instance has come down all the way from levels closer to 2.6% in October to currently 2.15%. Even central banks themselves have become more positive about the disinflationary tendencies taking hold.

On the heels of the FOMC meeting rates markets in the US will look out for the initial jobless claims as well as retail sales data today. We will also get import and export prices.

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