

Rates Spark: Update on the rates view in light of latest impulses

The latest French and Spanish inflation numbers chime with recent US inflation numbers that show some stickiness attached to the inflation narrative. It keeps both the European Central Bank and the Federal Reserve in hiking mode. Here we update on the cycle for rates ahead, noting 5% and 3% as key levels on the horizon for both ends of the curve



The cycle we expect on the front end; dominated by hikes for now

Given what we know, we agree that the Fed will hike by 25bp per meeting for the next three meetings. That takes the funds rate range to a peak of 5.25% - 5.50% by June. Here's where the Fed stops. It's also reasonably consistent with the dot plot, which will make the Fed feel good about itself. Moreover, the cumulative delivery of 550bp of rate hikes (all the way from zero) is quite a dramatic rise in the cost of leverage for households and corporates. Even if it just holds there for a number of months it will add stresses and strains to the economy.

The increased cost of leverage has an impact effect, a cumulative effect and a persistence strain

The increased cost of leverage has an impact effect, a cumulative effect and a persistence strain. Even if players had ridden through the rate hike process to date and have felt some tolerable pain, that pain will continue to cumulate. US corporates will be in no mood to go on investment sprees in such an environment. And even though there has been a reluctance for employers to shed employees (as it was tough to get them in in the first place), in all probability lay-offs are liable to creep in as we progress further through 2023. There is a moment where inflation and higher rate costs really hit home.

And this is why we think the Fed stops, and furthermore why we think the Fed will subsequently engineer some sizeable cuts. Our Chief International Economist James Knightley thinks the Fed can be in the rate cutting game by end-2023, and in any case through 2024 watch out for at least 200bp of interest rate cuts. Why? By the third quarter of the year the realisation will grow that the inflation threat has been significantly downsized, and the Fed will then focus on its second mandate, which is to facilitate a strong jobs market. By this time, employment reports will have turned to low to negative, requiring some support from the Fed, to prevent ongoing (by then) rises in the unemployment rate.

Then we get pause and then cuts, with 3% and 5% handles key levels for market rates

The 5% handle for the funds rate in all probability gets reduced down to a 3% handle. In fact we have the funds rate bottoming out at 3% flat in 2024. And before the funds rate gets to 3%, the 10yr Treasury yield is liable to get down there ahead of that. As higher interest rates really begin to bite and the recessionary tendency takes hold in the second half of 2023 the 10yr yield is liable to overshoot to the downside, getting to that 3% level. However, note that we characterise this as an overshoot. What we are saying here is 10yr yield should not go below 3%. Or course it could. But it really shouldn't. And if it does, it should only be temporary.

We are in a new world here where there is a more inflation prone set of circumstances

This reflects our view that we are in a new world here where there is a more inflation prone set of circumstances that does not merit super-low rates like we've had in the previous decade and a half. Those super-lows were brought on by the Great Financial Crisis and reaction to the pandemic. Mean reversion to the 2% area seen for the US 10yr yield through these years does not make much sense going forward. We'd view 3% as a more suitable starting point, which can be broken out as 2% - 2.5% inflation and 0.5% to 1% real rate. In consequence that's our target for the Fed funds rate bottom, and if that's the bottom for the Fed, then the 10yr should not really be going below it.

Which brings us to the pivot narrative. We've been a bit frustrated with the market obsession with this term throughout 2022. There is no pivot. There is a hiking phase (ongoing), a pause phase (second and third quarters of this year) and then a cutting phase that we believe starts in the fourth quarter and really takes hold through 2024. This cutting phase helps to cushion an economy that had finally caved to the prior interest rate elevation pressure. It can't be overdone though as the US economy is more prone to inflation going forward. Bringing jobs back home does not mean cheaper jobs; de-globalization the same.

That's based on what we know. Throw in another crisis and we go off on another tangent. Geo-politics always has the potential to engineer that too. But until it happens, it cannot be fully discounted. That all being said, one of the logical reasons for the remarkable early and deep inversion of the US curve is that longer maturities are a bit nervous about the future. Putin's war in Ukraine shows how uncertain the wider world is, and how impacts from such events become global really quickly. And its ongoing. The Fed does what it can to focus on the US economy. The markets watch the Fed, and lots of other stuff that pushes things around; always quite a complex web.

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