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What is going on in the bond markets?

Sonia Renoult
Rates Strategist
sonia.renoult@nl.abnamro.com

Bill Diviney
Senior Economist
bill.diviney@nl.abnamro.com

- **A sharp jump in market interest rate expectations has led to a surge in US and EU rates**
- **In this note, in Q&A format, we look at the drivers of the move so far and make an assessment of whether the rise in yields can be sustained**
- **Recent macro data do not justify the move, and inflation expectations have been stable, suggesting the rise in yields is being driven by hawkish central bank guidance**
- **Longer tenors have seen the biggest rises in yields, with the 10y US and German bond yield rising by around 40bp in just two weeks**
- **Indeed, the market has been repricing higher policy rate not only for next year but also well beyond**
- **Based on the Futures curves, the Fed fund and ECB rate are now expected to hold above 4% and 3% respectively**
- **As such, volatility has moved along the yield curve to the longer-end due to the elevated uncertainty regarding the path of monetary policy and the economic outlook**
- **However, we continue to expect rates to start to come down by year-end and throughout 2024, on the back of the economic slowdown and continued disinflation**
- **Unperpinning this view is our expectation for a significant rate cut cycle in 2024, with cuts continuing until rates return to more neutral levels**
- **Furthermore, if the jump in yields continues at this pace, we would expect central bank officials begin to verbally push back against the tightening of financial conditions**

Introduction

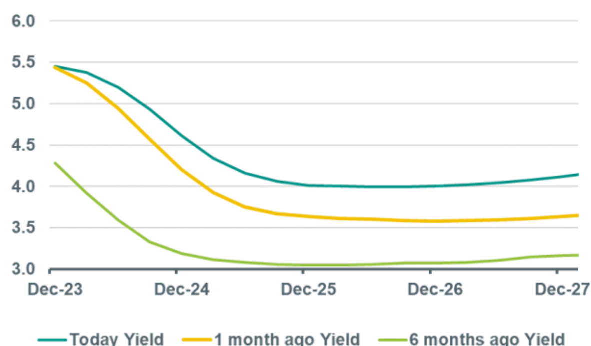
In recent weeks, the bond market has seen another hawkish lurch, leading to a significant repricing in central bank policy rates for 2024 and beyond which pushed short-term rate expectations to new highs. As such, the US and German 10y rate rose by more than 40bp in just two weeks. This recent move clearly reflects the new ''higher-for-longer'' theme being priced in by the rates market. The persistent hawkish speech from central bank officials seems to have been well-heard this time and maybe even a little overinterpreted. Indeed, we judge the sudden rise in long-term bond yields by the market to be overdone and not backed by any significant changes in the economic fundamentals. We will attempt to shed some light on the recent bond market developments in Q&A format and provide our view on the way forward.

What is pushing long-term rates higher?

Despite the end of the rate hiking cycle looming (or even having ended in our view), long-term interest rates continued to rise with the 10y US and Bund yield breaking new highs last seen about 15 years ago (now trading at 4.8% and 2.98%). This recent surge in yields is mostly driven by a fresh surge in interest rate expectations. But this time the rise has expanded further along the futures curve, which explains why this repricing has affected longer-term rates the most while short-term rates seem to be close to their peak. As shown in the graphs below, when comparing the futures curve (SOFR for the US and Euribor futures for the EZ), there has been a significant repricing upward of the Fed and ECB policy rate. The Fed funds rate is now expected to hold at more than 4% until 2027 (versus 3.2% 6 months ago) and the ECB rate to stay above the 3% rate in the coming years.

Market's LT rate repricing rose by 80bp in the US…

3-Month SOFR Futures (in %)



Source: Bloomberg, ABN AMRO Group Economics

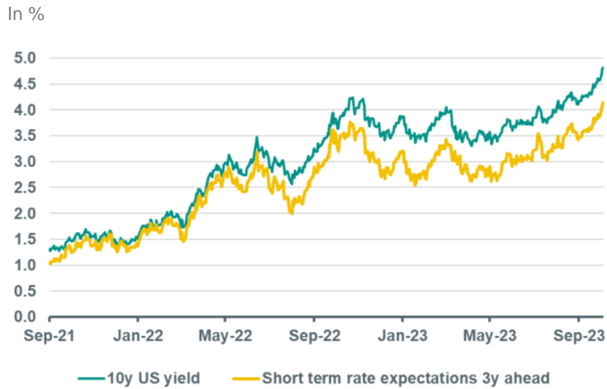
… and by 50bp in the Eurozone

3-Month Euribor Futures (in %)

Source: Bloomberg, ABN AMRO Group Economics

This repricing of interest rate expectations has been the main driver of higher bond yields. The 10y nominal bond yield tends to move closely together with short-term rate expectations (as shown below) and this one has indeed risen again recently to a new peak. In our view, the market is taking the higher-for-longer rhetoric too far. Particularly when looking at the economic outlook (as discussed in the section below), our rates conviction remains for rates to fall by year-end and throughout most of 2024.

Short-term rate expectations continue to be the key…



Source: Bloomberg, ABN AMRO Group Economics

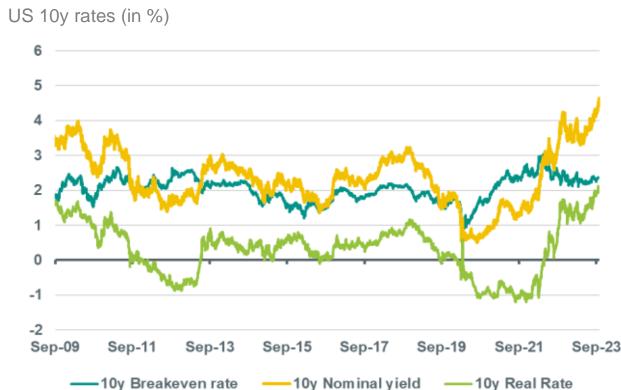
… driver of longer-term interest rates

Source: Bloomberg, ABN AMRO Group Economics

Finally, if we decompose the nominal bond yields, we see the ''higher-for-longer'' reflected there as well. The (risk-free) nominal bond yields can be decomposed into two factors: the Breakeven rate (which refers to the inflation component) and the real yield. As shown below, the recent surge in the 10y nominal bond yields has been mainly driven by the real yield component rather than the breakeven rate, which has remained relatively stable and well anchored around the 2% target.

We see three key reasons behind this surge in real yields. First, the rise could imply that the market's neutral rate expectation has been rising, implying higher economic growth expectations as well. Thus, some argue that it would explain the economic resilience of the US economy despite the aggressive monetary policy tightening of the Fed. This first point clearly contrasts with our macroeconomic outlook discussed in the next section. In addition, the most recent Fed's estimate of the neutral rate also contradicts that view. The second reasoning reflects more the scenario of structurally higher inflation which means central banks would have to keep (real) rates higher for longer to contain inflation in the long run.

Nominal bond yield rise is driven by real yields…



Source: Bloomberg, ABN AMRO Group Economics

…with the 10y breakeven rate remaining stable

Source: Bloomberg, ABN AMRO Group Economics

We tend to lean more on a third reason which is that the rise in real yields is being driven by the persistent hawkish tone of central bankers rather than by a significant change in the macroeconomic outlook.

Volatility still the name of the game in the rates market?

The fall in rates volatility since the banking crisis turmoil in March has been interrupted by the recent surge in rates. Even after that decline, volatility in the rates market was still historically elevated (proxied by the MOVE index) while the volatility in the stock market (measured by the VIX index) has come back to the pre-covid level. Furthermore, the renewed rise in volatility has been skewed to long tenors, hence the biggest moves have been in the 10y rate rather than the 2y rate as we had in previous months. Given that we have now likely seen the end of the rate hike cycle, uncertainty has shifted toward where policy rates will settle in the longer run rather than the actual start of the rate cut cycle. This increased volatility in the longer part of the curve likely reflects uncertainty among market participants over whether the fight against inflation is really over and so on the monetary policy path going forward. Volatility in the rates market will likely take time to normalize, as the narrative driving markets appears to change almost on a weekly basis. Until the market gets further clarity on the monetary policy going forward and the economic outlook, it will be difficult to see rates on a sustained downward path.

Has anything on the macro side changed to cause this shift?

No. While the recent rise in oil prices naturally puts upward pressure on headline inflation, economic weakness in the eurozone and softening labour market data in the US suggests this will be short-lived, and that the broad disinflation trend is intact (see our Global Monthly for more on this). Most of the post-pandemic labour market tightness in the US has unwound, and wage growth is now back near pre-pandemic levels. Wage growth also looks to have peaked in the eurozone and is now an asset for a declining trend. Given that wage growth is the main longer-run determinant of inflation, this gives us confidence that inflation will be back near the Fed & ECB's 2% target by the end of 2024.

Is inflation going to be structurally higher over the coming years?

We don't think so. One possible explanation for the rise in bond yields is that we are moving to a new inflationary paradigm – where increased trade barriers due to geopolitical tensions (deglobalisation), the energy transition, and increased climate shocks push inflation structurally higher. As we describe above, this view is not evident in breakeven-implied inflation expectations, which have barely changed in recent months.

As the economist Milton Friedman once put it, inflation is "always and everywhere a monetary phenomenon." Put another way, if a central bank wants to, it can bring inflation back to a given level as long as it is prepared to accept the pain of weaker growth outcomes as a consequence. Indeed, central banks have been doing just that over the past two years, raising rates at the most aggressive pace in decades, and running a major risk of a deep economic downturn in the process. They acted in this way in order to prevent a feared de-anchoring of inflation expectations, and so far at least they have been successful, because inflation expectations have indeed remained well-anchored.

With real yields rising and inflation expectations holding steady, this implies that markets have changed their view on the level of interest rates that are needed to keep inflation anchored near central bank targets.

What if longer run inflation expectations were to start rising? This would suggest not only that the market thinks there will be further shocks that push inflation higher, but also that central banks would tolerate such a rise in inflation on a sustained basis. This last point is crucial. In the long-run, the rate of inflation is driven by inflation expectations. Shocks can (and often do) move inflation away from this long-run anchor, but as long as the central bank remains committed to its inflation target, the anchor holds. Inflation becoming structurally higher would therefore be a choice – not something that happens by accident.

Given this, and given that we have not seen any indication from central banks that they would be any less determined to fight a future inflation wave than they were in the most recent episode, we do not expect inflation to move structurally higher over the coming years. What we cannot rule out is that the shocks to inflation become so frequent and so severe that the economic consequences of bringing inflation back down become intolerable, and therefore central banks adopt higher inflation targets (implicitly or explicitly). However, this seems a rather extreme scenario to us and not what one we would have as a base case at this point.

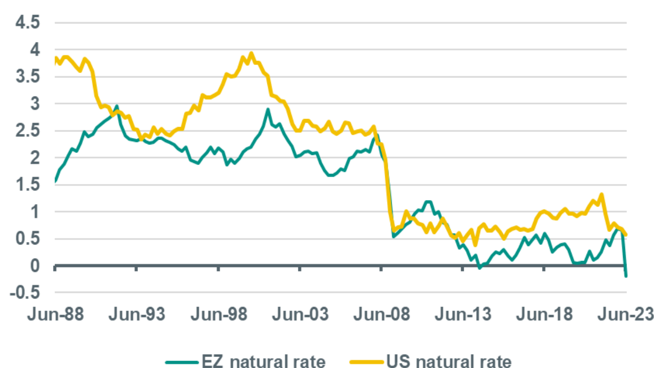
Could the neutral rate be higher?

As discussed above, real yields can serve as a market proxy for the neutral rate level. Indeed, the recent surge in real yield has sparked the old debate about the true level of the neutral rate. Some argue that the rise in real yields is an indication that the neutral rate has risen and thus, could also explain the resilience of the US economy despite the aggressive rate hiking cycle.

However, it is important to note that various factors influence the real neutral rate and some are temporary in nature. A recent publication from the Federal Reserve Bank of New York highlighted the short-term factors of the neutral rate and explained most of the rise since December 2022 thanks to attractive financial conditions (referred to here as corporate bond spreads). As financial conditions remain accommodative with corporate spreads and equity risk premiums at tight levels, this supported the short-term component of the neutral rate up. But as financial conditions continue to tighten and the AI wave that fueled the stock market earlier this year is fading, this driver is expected to reverse which will gradually bring the real neutral rate down again with it. Meanwhile, the recent estimate of the long-run neutral rate by the Federal Reserve continues to suggest it is at historically low levels in both the US and the Eurozone.

Laubach Williams model suggests lower neutral rates

Holston Laubach Williams Natural Rate of Interest (%)



Source: ABN AMRO Group Economics, Federal Reserve Bank of New York

Ultimately, neutral rates are only truly knowable after the fact, i.e. after the impact on the economy has become visible. In that regard, it is notable that credit growth has slowed sharply on both sides of the Atlantic, loan demand has weakened and bank lending standards have tightened. In response, the eurozone economy has already weakened considerably and is teetering on the brink of recession, while in the US, although growth has been more resilient, there has been a clear and significant softening in the labour market. Given this and given the lags with which monetary policy transmits through the economy, we judge that even if short-run neutral rates are temporarily higher, rates are likely well into restrictive territory at current levels.

We will publish a more detailed note on the neutral rate soon.

Could the Fed or ECB intervene verbally to counter market moves?

The move in bond markets matters for central banks, because, as the benchmark risk-free rate upon which credit markets function, bond yields are the primary transmission channel for changes in monetary policy. Indeed, to some extent, the rise in bond yields reflects what central banks have been telling markets in recent months: that rates are likely to stay 'higher for longer' than previously thought. However, markets may be over-interpreting this message, and a hint of this was evident in comments last week by Chicago Fed president Goolsbee, who said that if bond yields keep rising, 'the Fed would have to take account of that as a form of tightening'. Still, other central bank officials – notably Fed Chair Powell – have stayed silent on the issue so far, suggesting they may be comfortable with the rise in yields for now. This comfort with market conditions may not last if yield rise continues for much longer, although it is difficult to pinpoint when (or at what level of yields) that might be. If central banks do intervene, we do not expect this to involve imminent rate cuts to counter the bond yield rise, but rather verbal intervention to prevent market expectations from running too far ahead of themselves. In this regard, central banks are the 'adults in the room' – there to temper market tantrums from getting out of hand.

A similar reaction can also be expected on the ECB side given that market-based financial conditions are tightening at close to the levels seen during recent financial crises as well as the recent rise in peripheral spreads. Some pressure seems indeed to have flared up on the 10y BTP-Bund spread widening last week by 10bp and approaching the 200bp level again. This

spread widening comes in part due to the recent tension on the budget 2024 and the rising deficit forecast by the Italian government. However, this higher-for-longer narrative also adds extra pressure on spreads. Thus, this might lead some ECB officials to soften their language to prevent a new abrupt rise in spreads, which would make the intended longer restrictive policy difficult to maintain.

What is the outlook for rates?

Despite the recent rises in yields, our conviction remains for rates will come down by year-end and throughout 2024 based on our macro outlook (see our Global monthly) and an expected shift in central bank guidance. On the eurozone side, assuming that our recession scenario plays out, this means that inflation as well as the real yield component of nominal interest rates will stabilize and come down. In addition, we expect the ECB to start its rate cut cycle in March 2024 and to continue cutting by 25bp at each central bank meeting. This will bring the deposit rate to 2.25% end of 2024 which means a significant repricing will need to occur, both in the short-term and longer-term part of the curve, to reflect this level.

EURO Rates Forecast	Now	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4
Deposit facility	4.00	4.00	3.75	3.25	2.75	2.25
Refi	4.50	4.50	4.25	3.75	3.25	2.75
Marginal lending	4.75	4.75	4.50	4.00	3.50	3.00
ESTR	3.90	3.90	3.65	3.15	2.65	2.15
3m Euribor	3.96	3.85	3.60	3.15	2.70	2.25
2y Germany	3.22	2.90	2.60	2.35	2.00	1.65
5y Germany	2.86	2.45	2.25	2.05	1.95	1.75
10y Germany	2.97	2.40	2.25	2.10	2.00	1.90
30y Germany	3.18	2.55	2.45	2.35	2.30	2.25
Germany 2s5s	-36	-45	-35	-30	-5	10
Germany 2s10s	-25	-50	-35	-25	0	25
Germany 5s30s	32	10	20	30	35	50
Germany 10s30s	21	15	20	25	30	35

Source: Bloomberg, ABN AMRO Group Economics

On the US side, we have recently revised our rates forecast upward for the following reasons: change in our macroeconomic base scenario for the US to a no recession, higher Fed fund's rate end-2024 (3.75% end of 2024 vs 3%), significant Treasury supply combined with QT, and potentially higher term premium on the back of this former factor as well as the risk of another downgrade by Moody's due to dysfunctional political environment which has led to periodic debt ceiling impasses and (the threat of) temporary government shutdowns. However, the rates outlook follows a similar trajectory to the EU rates given the sharp slowdown we expect later this year, the significant disinflationary progress that has already been made, and the subsequent normalisation of Fed monetary policy.

US Rates Forecast	Now	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4
Federal funds rate-upper	5.50	5.50	5.25	4.75	4.25	3.75
IOER rate	5.40	5.40	5.15	4.65	4.15	3.65
2y Treasury	5.14	4.35	3.80	3.50	3.25	2.85
5y Treasury	4.81	4.00	3.75	3.50	3.30	3.10
10y Treasury	4.81	3.85	3.70	3.55	3.35	3.25
30y Treasury	4.93	4.10	4.00	3.90	3.80	3.75
Treasury 2s5s	-33	-35	-5	0	5	25
Treasury 2s10s	-34	-50	-10	5	10	40
Treasury 5s30s	12	10	25	40	50	65
Treasury 10s30s	12	25	30	35	45	50

Source: Bloomberg, ABN AMRO Group Economics

In the end, given the recent economic development in both the US and EZ, with core inflation slowing down, labor market deteriorating, and intensification of financial tightening, an economic slowdown is on the cards in our view. Weaker economic activity is indeed likely to weigh on short-term rate expectations which will push the 10y yield lower in turn. Therefore, we judge that the market should reflect better this economic outlook once the higher-for-longer theme subsides and thus will be supportive of lower rates.

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