bankSA

Monday, 20 November 2023

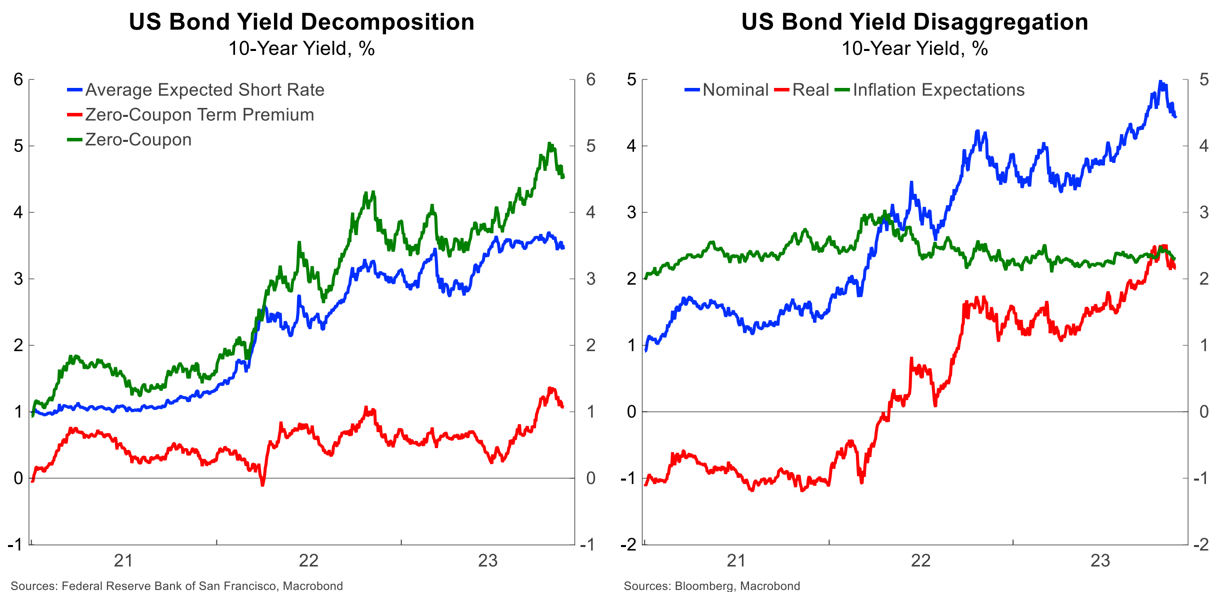
What Goes Up, Must Come Down

The last few months have been marked by significant volatility across US and global bond markets. Bond yields have seesawed sharply between hitting some of the highest levels in decades and then pulling back materially in recent weeks. The US dollar also joined the party, firstly on the way up and now on the way down, as interest rate differentials impacted currency movements.

The US 10-year bond yield surging to above 5% in late October. It hit a peak of 5.02% on the 23rd of October – the highest since July 2007. The 30-year yield similarly spiked to a level not seen since July 2007, touching 5.18%. These moves had been building for quite some time after the 10-year yield began trending higher from its 2023 bottom of 3.25% in April.

More of the action happened at the longer end of the yield curve. Moves in the policy-sensitive 2-year yield were less significant. Although the 2-year yield did still increase and hit 5.26% – a peak not seen since June 2006.

These moves largely reflected a rise in the term premium (the compensation investors demand for investing in long-term bonds versus short-term bonds) and real yields (which strip out expected inflation and likely volatility around expected inflation from nominal yields).

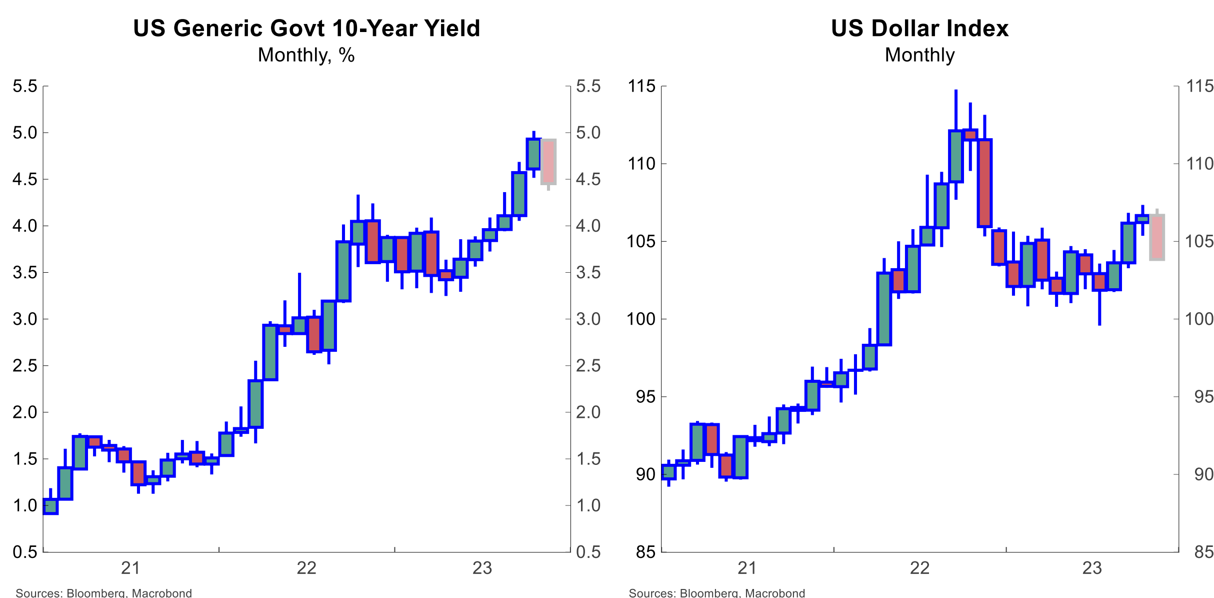


It seemed that market participants were absorbing the message from the Federal Reserve, who had been trying to convince them that interest rates would remain higher for longer to get on top of elevated inflationary pressures.

A range of factors have been suggested as potential explanations for the rise in the term premium. It is difficult to know the exact contribution of each driver and the moves likely reflected a combination of factors. Proposed drivers include:

- stronger-than-expected real US economic growth suggesting that the economy was more able to sustain higher rates;
- investors requiring increased compensation for greater uncertainty around the level and volatility of long-term economic growth;
- increased supply of treasuries due to larger fiscal deficits and increased US Government borrowing needs and the US Fed adding to supply through quantitative tightening;
- uncertainty around demand from less price-sensitive buyers such as governments; and
- changing correlations between bonds and equities meaning that bonds may provide less of a hedge to equity portfolios in the future. This could lead to bond investors demanding greater compensation (i.e. higher yields) for bearing risk.

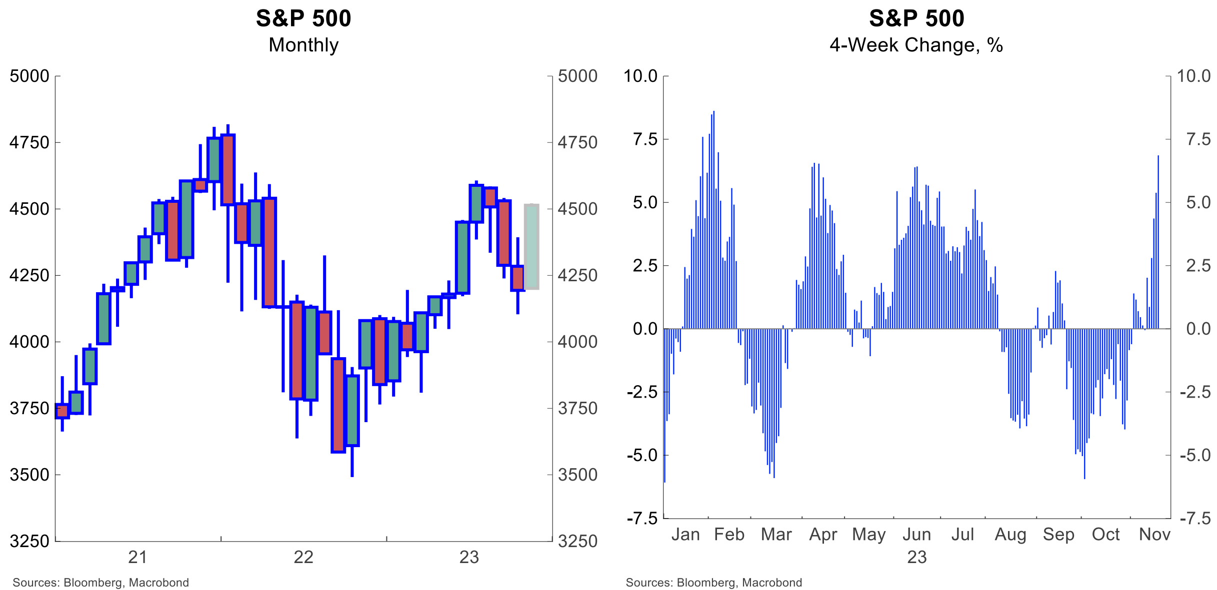
But just as quickly as bond yields shot up in the past two months, they began to reverse course in recent weeks and have unwound all of October's moves. The US dollar has also sold off against a basket of currencies and is currently around its lowest level since early September.



What caused these moves? Typically, there are numerous catalysts for significant market movements. This time was no different. However, bond yields began their sharp fall after the Fed's November meeting. The outcome was as expected – a pause – however, markets looked to changes to the statement and Fed Chair Powell's commentary for guidance. The inclusion in the statement of "financial conditions" being "likely to weigh on economic activity, hiring, and inflation" – in addition to the previously mentioned credit conditions – was viewed as a dovish tilt. Chair Powell's press conference was also interpreted as suggesting that the probability of future hikes was lower than previously priced. As a result, market pricing pulled back and other financial instruments, including bond yields and the US dollar, declined.

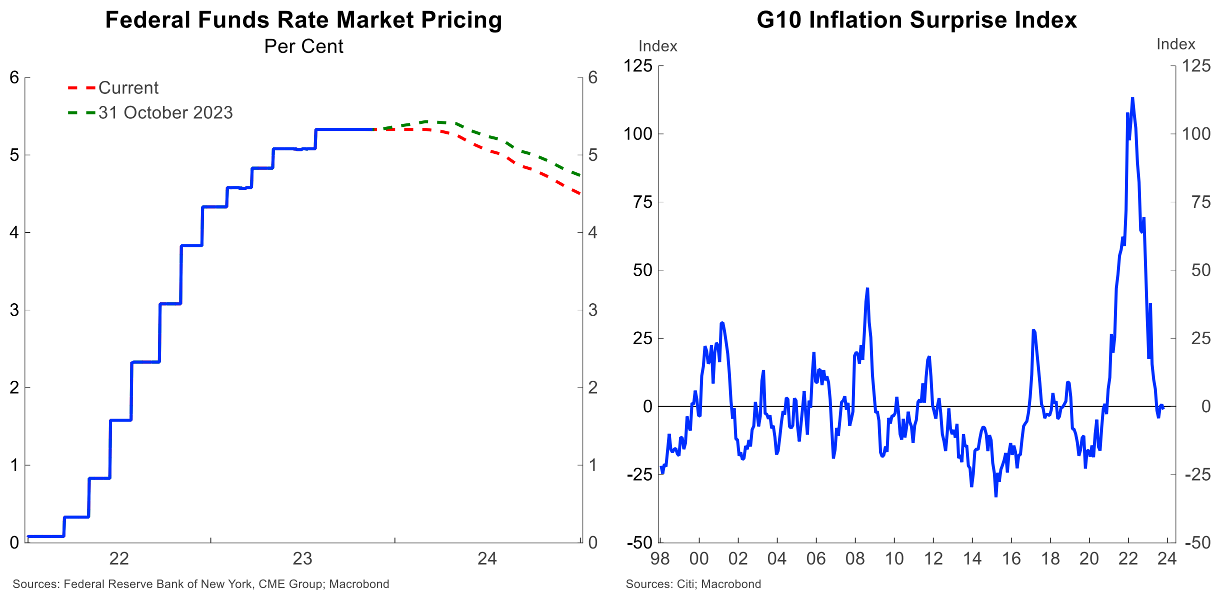
Added to this, there has been a recent run of US data suggesting that a fabled 'soft landing' – a continued slowing in inflationary pressures without a significant hit to the labour market and the US economy – may be possible without further hikes. This was underscored by a weaker-than-expected October inflation result. Indeed, recent inflation results have surprised slightly to the downside across G10 economies. This is in stark contrast to the experience of 2022 and early 2023.

While this has been happening, equity investors have rejoiced as falls in discount rates lead to increased valuations (all else being equal). The S&P 500 and other equity benchmarks have rocketed in November. Over the past four weeks, the S&P 500 surged 6.9% – the strongest four-week jump since February 2023.



What does this mean for the future?

Markets are now firmly priced for no more hikes from the Fed. Indeed, rather than hikes, interest-rate markets have almost four cuts priced into the profile for 2024. This compares to around a 40% chance of one more hike prior to the most recent Fed meeting.



Our Group view is that the Fed is done hiking. Looking into 2024, we expect a continued slowing in inflation will allow the Fed to begin cutting rates gradually through 2024 and 2025.

As Jerome Powell and other Fed members have noted on numerous occasions, the Fed is seeking to maintain tight monetary policy settings, in real terms. This means that as the actual rate of inflation comes down, the Fed will need to cut the policy rate to ensure that real monetary policy settings don't tighten further. This is an important point to keep in mind, as monetary policy won't

loosen as rapidly as one may first think if only looking at nominal, not real, yields.

However, the US is not out of the woods yet. While the balance of risks implies that policy rates and yields are likely to gradually decline over 2024 and 2025, a spike higher in yields or a more protracted period of rates and yields remaining at elevated levels can't be ruled out.

It is important to remember that markets have been head faked in the past. Bond yields declined sharply in March of this year as the banking turmoil in the US and Europe unfolded, culminating in the collapse of three US banks and the government-brokered takeover of Credit Suisse by rival UBS. But after financial conditions and contagion risks stabilised, yields trended higher through much of the rest of 2023, before this recent volatility.

It remains important to closely monitor the flow of data as central banks continue their fight to get inflation back to target in a reasonable timeframe. Some bumps in the road ahead are likely.

On the economic data front, key leading indicators – in the form of the S&P November Purchasing Managers' Indices – will be published this week. Indicators for the US, Europe, the UK, Japan, and others will be released. These leading indicators provide important insights into how business conditions are evolving and have strong relationships with official economic growth and inflation data. The prices paid and received components will be watched closely for further signs that inflationary pressures continue to slow and if the US remains on its narrow path to achieving a soft landing.

Domestic data

It is a quiet week on the domestic front as we prepare for a busy end of year with September quarter GDP data due in the first week of December, in addition to a raft of economic data ahead of that release.

But this week, the main item to watch is the release of the minutes from the Reserve Bank's (RBA) November meeting. These minutes allow analysts to better gauge the Board's thinking at the time of the meeting. However, with the Statement on Monetary Policy released on the Friday after the meeting, the degree of new information is expected to be lower than usual.

In addition to the minutes, there will be other appearances by RBA officials. Key of those will be a speech on Wednesday evening by RBA Governor, Michele Bullock, titled: *A Monetary Policy Fit for the Future*. The speech will provide an update on the implementation of recommendations from the Review of the Reserve Bank, delivered in March this year. Additionally, the Governor will speak about the latest monetary policy decision and economists will be watching for any clues on the future path of monetary policy.

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Group Forecasts

		2023	2024				2025
End Period:	**Close (17 Nov)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.35	4.35	4.35	4.35	4.10	3.85	3.60
90 Day BBSW, %	4.38	4.55	4.55	4.47	4.22	3.97	3.72
3 Year Swap, %	4.31	4.50	4.40	4.30	4.20	4.10	3.90
10 Year Bond, %	4.47	4.70	4.60	4.50	4.40	4.30	4.15
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.44	4.80	4.70	4.60	4.50	4.40	4.20
USD Exchange Rates:							
AUD-USD	0.6515	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	149.63	149	147	144	141	138	135
EUR-USD	1.0915	1.08	1.09	1.11	1.13	1.14	1.15
GBP-USD	1.2462	1.23	1.24	1.25	1.26	1.27	1.28
NZD-USD	0.5991	0.60	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6515	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.5969	0.61	0.61	0.61	0.61	0.61	0.62
AUD-JPY	97.48	98.3	98.5	97.9	97.3	96.6	95.9
AUD-GBP	0.5227	0.54	0.54	0.54	0.55	0.55	0.55
AUD-NZD	1.0876	1.09	1.10	1.11	1.11	1.12	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	4.6	3.4
CPI (Trimmed mean), %	2.6	6.8	4.4	3.3
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.4	3.3	4.1	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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