Rate Cut Fever

Markets have been on fire since late October, with equities marching higher and bond yields tumbling, as investors bet on rapid rate cuts in 2024. The moves on stock markets have been large, with both the S&P 500 and Euro Stoxx 50 indices up by circa 11%. Meanwhile, bond markets have also made good gains, with ten year yields in the UK, Eurozone and US falling by 75-85bps.

In October, markets were looking for rate cuts of just 50bps from the ECB and US Federal Reserve next year. Futures contracts are now pricing in rate cuts of 135bps in the Eurozone in 2024, starting April. US rates are expected to be reduced by 110bps, beginning in May. Meanwhile, markets were pricing in further significant rate hikes from the Bank of England not that long ago, but now they expect 75bps in rate cuts next year.

The catalyst for the rate cut fever has been far bigger falls in inflation in recent months than had been expected by central banks and markets. In the Eurozone, inflation has fallen from 5.2% in August to 2.4% in November. Core inflation has declined from 5.3% to 3.6% over the same period. In the US, the core PCE inflation rate had declined to 3.5% by October from 4.3% in July. Meantime, the Eurozone economy looks to be in a technical recession, while the US economy is showing some signs of a slowdown. The UK economy is close to stagnation.

Overall, inflation looks set to return to its 2% target more quickly than central banks have been projecting. Indeed, there is now a risk that inflation may move below target in the next couple of years, against a backdrop of subdued global growth and the continuing marked decline in commodity prices. This raises the possibility that monetary policy may have been tightened too much in 2023.

Central bankers, though, have been pushing back on the notion of early rate cuts and will have the opportunity to do so again this week, at their final policy meetings of 2023. Obviously, rate cuts would represent a change in policy direction and central banks will want to be sure inflation has been tamed before setting off down that road. In this regard, the Fed and ECB will publish their latest quarterly set of macro-economic forecasts at this week's meetings. Downgrades to inflation forecasts are likely in both cases.

US core PCE inflation is already below the Fed's projected level for end 2023 of 3.7%. In the Eurozone, the ECB forecast is for inflation to average 3.2% next year, but the rate has already dropped to 2.4%. While it is likely to pick up in December, it looks set to fall below 2% in early 2024. Meantime, further sharp falls in the annual rate of core Eurozone inflation are likely in the spring,

pushing it down close to 2%. The ECB's projection is for core inflation to average 2.9% next year. Thus, the ECB's headline and core inflation forecasts for 2024 both look set to be cut appreciably.

No changes to interest rates are expected this week at any of the central bank meetings. However, it is going to be hard for central bankers to dampen rate cut fever, when at the same time, they are lowering their inflation projections significantly.

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