



Central bank rate-cut pricing is eye-catching but deceiving

From the Field
February 2024

Traveling to meet with clients around the globe in early 2024, many have asked me about my outlook for interest rate cuts from developed market central banks. The financial media has devoted much attention to the surprisingly large number of 2024 rate cuts reflected in interest rate derivative markets. Market sentiment shifted dramatically with the dovish pivot from developed market central banks that started with the Federal Reserve in late November 2023 and gained steam in the eurozone and the UK in December and January.

Average pricing of rate cuts involves extremes

The level of easing implied by prices of futures contracts and other derivatives is simply an average of expectations priced in across a range of potential outcomes. In other words, this average captures the views of both those who think inflation will reignite, constraining rate cuts, and those who believe a severe economic downturn will result in aggressive rate decreases.

Part of the market projections for aggressive 2024 rate cuts reflects the fact that some institutional investors are using interest rate futures to hedge against the possibility of a deep global recession in 2024. These positions would benefit from the rapid loosening of monetary policy in a recession, ideally offsetting some of the losses sustained in the riskier parts of their overall asset allocation.

The Federal Reserve

In early February, U.S. federal funds futures contracts showed expectations for five rate cuts of 25 basis points by the end of 2024,¹ with the first move coming at the May Fed policy meeting. This was actually lower than the mid-January pricing that indicated seven cuts beginning in March. The blowout January U.S. nonfarm payrolls report that showed more than 300,000 jobs added was probably a major factor behind the tentative repricing of Fed cuts amid the volatility.

Could the Fed ease by 125 basis points over the course of the calendar year? It's



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¹ Source for all interest rate probability data: Bloomberg Finance L.P.

certainly possible—if the U.S. economy weakens notably, unemployment increases, and inflation continues on its downward trajectory. But so far there's little sign that any of these conditions are in the immediate future for the U.S. Another factor that could tilt market estimates of Fed easing toward more cuts is a flight-to-quality premium for the highest-quality assets, which is a form of risk hedging.

The European Central Bank

The eurozone economy looks anemic compared with the U.S. from a growth point of view, with pronounced weakness in the manufacturing sector. As of early February, the overnight index swaps² (OIS) market indicated that participants expected five 25-basis-point cuts in 2024 from the European Central Bank (ECB), with the first move in April. In January, OIS had showed expectations for six decreases. Given the weakness of the eurozone economy relative to the U.S., the projections for the same number of cuts from the Fed and the ECB make little sense, although inflation appears more entrenched in the eurozone.

The Bank of England

Turning to the UK economy, which may be in the worst shape of any major developed market, OIS data in early February showed

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that four Bank of England (BoE) rate cuts were probable by the end of the year. At first glance, it may seem incongruous that markets were projecting fewer rate reductions from the BoE than from the Fed. However, UK inflation, while down from its very elevated levels in 2022 and early 2023, is still much higher (and probably stickier) than in the U.S., giving the BoE a narrower needle to thread than the Fed.

Diverging yield curves

I think the various developed market government yield curves will react to central bank easing in different ways. In the U.S., I expect the Treasury curve

to steepen as rate-cut expectations drive short-term yields lower while longer-maturity yields stay relatively steady—this “bull steepener” is a historically typical reaction to impending monetary policy loosening.

In the eurozone, where markets in early February still priced in the first ECB rate cut in April, I expect a different German sovereign yield curve dynamic. I anticipate the first ECB move in June, not April, so the German curve would likely “bear flatten” as short-term rates that had been priced for an April cut instead move higher. The UK sovereign yield curve will probably experience a similar bear flattening as the first BoE rate cut that markets currently project for June seems too early.

Lumpier cuts more likely than smaller insurance cuts

Stepping back to take a broader look at developed market economies and monetary policy, I think that “lumpier” rate reductions in larger increments that start later in the year are more likely than the series of steady insurance cuts in smaller increments that many appear to expect. This fits into my view that inflation will ultimately prove to be stickier and growth less resilient than recent data have shown, forcing central banks to keep rates steady before rapidly loosening as economic growth slows.

² An overnight index swap is a transaction involving one party paying the overnight lending rate in exchange for receiving a fixed rate agreed upon by both parties.

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