

The Major bond letter

#42. Going binary

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Fixed Income - Rates

Global

It's that time of year when bond analysts are busy reassessing what informs their views, crunching numbers, and ultimately making forecasts for rates and yields. Some might be influenced by momentum behind recent moves, and more than a few will follow closely central bank guidance.

Fuelled by a big swing in US rate expectations, the debate about where bond yields will be in 2024 is heating up. Most market participants accept that the rate increases are now behind us, with the last hike having been in July, so the outlook for the upcoming decisions has become somewhat binary: unchanged or down.

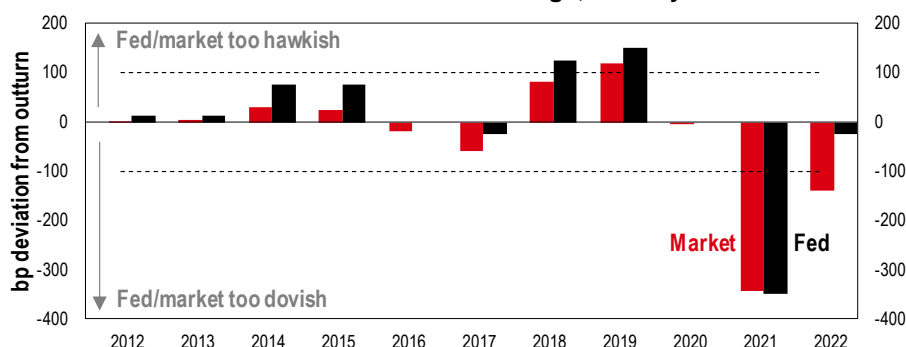
Is the market pricing in too much or too little? In this bond letter we explain why it is better to understand what's driving the difference in the numbers, before making a call on whether numbers are too high or low.

First, a forecast is not to be confused with a forward rate. The forward is a probability-weighted estimate of where rates will be at a given point in the future. So, the 1Y1M – the forward for one-month money market rates starting one year in the future – captures all possible outcomes.

If, for example, the US forward is 125bp below today's policy rate, it does not mean that markets are forecasting this amount of rate cuts. Rather, it is the aggregate of all views expressed in the market. In a simple two scenario model, it is the aggregate of a 50% probability of 250bp in rate cuts and the same weighting for unchanged.

Forecasts, on the other hand, reflect a baseline for the path and destiny of rates over a given time. The Federal Reserve gives us a median expectation from its "dot plot" in the quarterly Summary of Economic Projections, with the next update coming at the meeting on 12-13 December. Individual forecasts by market practitioners are complemented with a median consensus, but this is not probability-weighted and invariably looks very similar to central bank projections.

Market forwards and Fed forecasts: Often too high, recently too low



Note: 'Fed' shows the one year ahead median Fed December dot plot forecast for the Fed funds rate minus the actual Fed funds rate one year later. So, 2022 shows the December 2022 median Fed dot for 2023 minus the actual Fed funds rate at the December 2023 Fed meeting, which is assumed to be 5.50%. 'Market' shows the 1Y1M USD OIS forward minus the actual Fed funds rate one year later.

Source: Bloomberg, HSBC

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Second, the track record of both market forwards and Fed forecasts shows large over-and under-estimations, outside of periods when rates were at the zero bound. The Fed and the forwards have often been more than 100bp either side of what actually happened. We can see this by comparing expectations from the Fed and forwards with what was realised. Our chart takes the December forecasts from the Fed for one year hence and the one year forward swap rate. We then subtract the realised rate; i.e., what actually happened a year later.

In the last two years, both the Fed forecasts (in black) and the market forwards (red) have been too dovish; they massively under-estimated the hikes that were to come. The most extreme example was December 2021, when the surge in inflation expectations resulted in a rapid period of rate hikes, with the market forward and Fed under-estimating these by 344bp and 350bp respectively.

When the policy rate was at the zero bound and the Fed committed to keeping it there, underwritten by forward guidance and QE, there was very little margin for error. The chart shows this for 2012, 2013, and 2020. These are years when the rate was at zero. In more 'normal' times, outside of QE and guidance that rates would stay on the floor, the typical outcome is overestimation, particularly from the Fed forecasts (shown in black).

Third, market measures of where rates and bond yields will be in the future have seen large swings in the risk premium, a measure of the uncertainty about future outcomes. Our chart shows the biggest under-estimation in the last two years, where both market forwards and Fed forecasts were way too dovish.

Conditioned by this recent experience, it should be no surprise that markets have imbedded a higher risk premium. We see this in two key market measures: the Fed's longer-run neutral rate (r-star), visible through five-year real forward yields, and the term premium, the compensation investors demand for buying longer-maturity bonds. These largely explain the huge swing in the markets of late.

The Fed's median for the r-star, inferred from the longer-run dot, is 50bp. As the dispersion of forecasts has been drifting up over the last two years, to be conservative we put this at the bottom of a 50-150bp range. Given forward real yields have been close to 2.0% for much of the year, there has been a sizeable risk premium, with how large depending on the r-star estimate.

Term premium seems to have taken a round trip, rising by as much as 100bp from July through October, on a market narrative of an imbalance between the supply and demand for bonds, only to fall back down again in November.

Fourth, even though market forwards are pulled by the possibility of extreme outcomes, and embed sizeable risk premia, they often had less error than the median path projected by the Fed and other forecasters. Most of the time the forward does a better job than the forecast, at least that's what our chart says based on 11 years of published Fed rate projections.

Some market participants will see the recent extreme moves in our chart as a sign that the world has changed, such that equilibrium neutral rates will have to be a lot higher. A similar argument is that the term premium needs to increase in compensation for an uncertain future. Our view is that market yields incorporate a sizeable risk premium on the **possibility** that the world has changed, not the **certainty** that it has.

At some point in 2024, rates are likely to be heading down. How much longer key policy rates stay where they are depends on the data or some kind of surprise event.

Forecasts are not the same as forwards, neither have a stellar track record in predictions, and a lot of these are in any case clouded by high risk premia. The key message is that markets know that the outlook for rates has become binary and are prepared to attach a higher weight to a large downward move.

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