

The Major bond letter

#43. Rates Ryder Cup

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Global

Expectations for lower rates in Europe and the US are running toe-to-toe. Regular readers of this letter know that we are fond of sport analogies (see [#27. Funny old game](#), 29 November 2022 and [#30. Score draw](#), 28 February 2023), so we couldn't resist a bit of golf.

The Ryder Cup is the biennial men's competition between Europe and the US, when the best golfers from the two continents slug it out at the highest level. Some will consider it to be the greatest sporting event in the calendar, and it's a shame that we have to wait until 2025 for the next one. In the meantime, we'll make do with what's shaping-up to be the bond market equivalent.

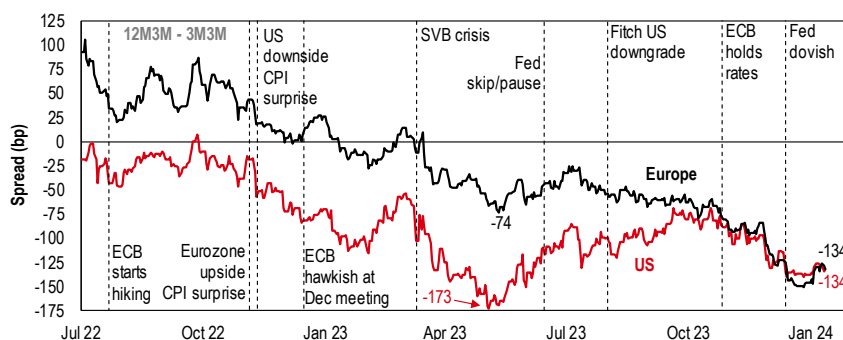
At the beginning of 2024 almost all market participants will agree that the next move in rates is down ([#42. Going binary](#), 11 December 2023), so now it's about the timing and magnitude. For bonds it's all about rate expectations, and here we are referring to the European Central Bank and Federal Reserve. Who goes first and by how much will they cut?

Our chart shows that market expectations are set for rate cuts of more than 100bp for both central banks. What's unusual is that the US normally has a larger and earlier implied move than the ECB. Futures contracts suggest the first cut could come as soon as March for both, and this is where most market participants would push back. It just feels too early to be anticipating rate cuts for the first quarter of 2024.

When considering the outlook for the sporting event, expectations would likely be based on past and present form of individual players, together with what the bookmakers are offering. Then there is the possible impact of wild card player choices, which don't run with form, providing an element of surprise.

For bonds we can substitute forward rates for expectations, representing a weighted average of everyone's current view. A measure of form requires us to look at history too, and the bond market wild cards will likely come from economic data, policy statements, or geopolitical shocks.

US and Eurozone one year ahead projected rate shift



Source: Bloomberg, HSBC. Note: US and European spreads are the difference between 12M3M and 3M3M USD OIS and ESTR rates, respectively.

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First, expectations. Our chart captures the difference between the three-month rate today, and a measure of where it will be in a year from now. It shows that the ECB and Fed are neck-to-neck, with market expectations for reductions of 134bp.

Second, let's look at the form. Since the first competition in 1927 the USA leads Europe with 27 victories to 14. But recent momentum favours Europe. They won in 2023 and have been on top throughout the last quarter of a century, winning nine times to the USA's four¹.

This latter period coincides with the existence of the ECB, founded in 1999, and here we find the form book reversed. The Fed has always led the ECB in the race to hike or cut rates, and maybe reflecting the respective mandates: the Fed focuses on both employment and inflation, whilst the ECB's primary objective is to maintain price stability.

In terms of rates, Europe has certainly been behind the US in this cycle. Since the ECB started hiking rates in the summer of 2022, the chart shows Eurozone rate cut expectations some 50-100bp less than for the US. Until recently that is. Rates went up by roughly the same amount on both sides of the Atlantic, but this does not mean they should fall by the same.

Third, wild cards. In golf these are players that, having not ranked high enough through the season for automatic qualification, were chosen at the captain's discretion. It is romance and nostalgia. Hopefully these players rattle up some of the old form, make a killer putt, perhaps a hole-in-one, whatever it takes to make a difference.

Wild cards in the bond market come from surprises. Yields are based on all available information, reflecting everyone's view on key determinants of the policy rate: inflation, growth, fiscal policy, and uncertainty about these three and much more. Markets can get it wrong, a lot. Failing to anticipate the rate hikes through 2021-23, and then more recently perhaps over-anticipating the turn in the cycle, until now maybe.

Just as a game of golf is over 18 holes, not just the last one, for bonds it's about much more than the next rate move. How far has today's policy rate diverged from the longer-run equilibrium? What if this equilibrium is much lower for Europe than the US, or vice versa? Then rate cuts might have to be deeper in one continent than the other.

Golf shows us how the form book can be turned on its head, and investors will have learnt this from the experience of the last few years. Amateur golfers fear duck-hooks, shanks, and the yips. Watching professional golf we can enjoy a lot of birdies, eagles, even the occasional albatross.

Likewise in bonds we can expect some surprises in the economic data and outsized market moves. It's highly unlikely we'll see the ECB and Fed moving tick for tick. Draws in the Ryder Cup are extremely unusual, the last one coming in 1989. We probably won't have to wait that long to get the winner of our rates Ryder Cup.

¹ The European side has evolved. In 1927 the competition was between Great Britain and the United States and then expanded to recognise Irish players (1973) and include continental Europe (1979).

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