



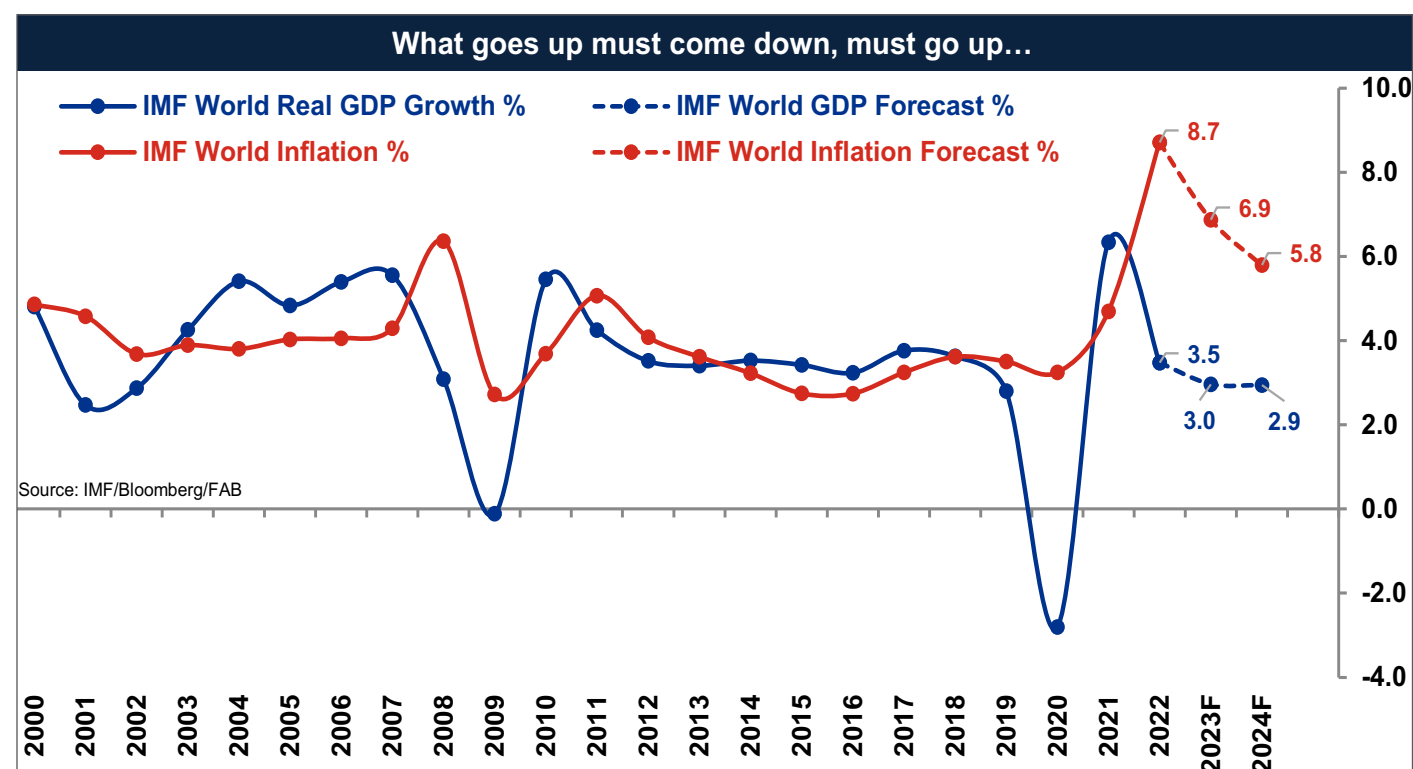
A GLOBAL MACRO RATES PERSPECTIVE ON 2024: VIEW FROM THE PLATEAU

Simon Ballard, Chief Economist

As we enter 2024, the global economic landscape looks to be at its most challenging in several years. The post-pandemic economic reopening and associated rebound appears to have run its course. At the very least we believe that economic growth momentum is beginning to show signs of suffocation under the grips of tighter financial conditions and a higher interest rate structure. This pressure is particularly intense in Europe; less so in the U.S.

Macro uncertainty and the increasing specter of

recession across much of Europe will likely act as a constrain for global interest rates over the first half of this year. At the very least, as financial conditions continue to tighten under the lagged constraints of past interest rate increases and as regional growth expectations are scaled back accordingly, there should be a growing understanding that global rates peaked in Q4 2023. The next move in rates, we believe, will be in a southerly direction, but probably not until the latter half of this year.

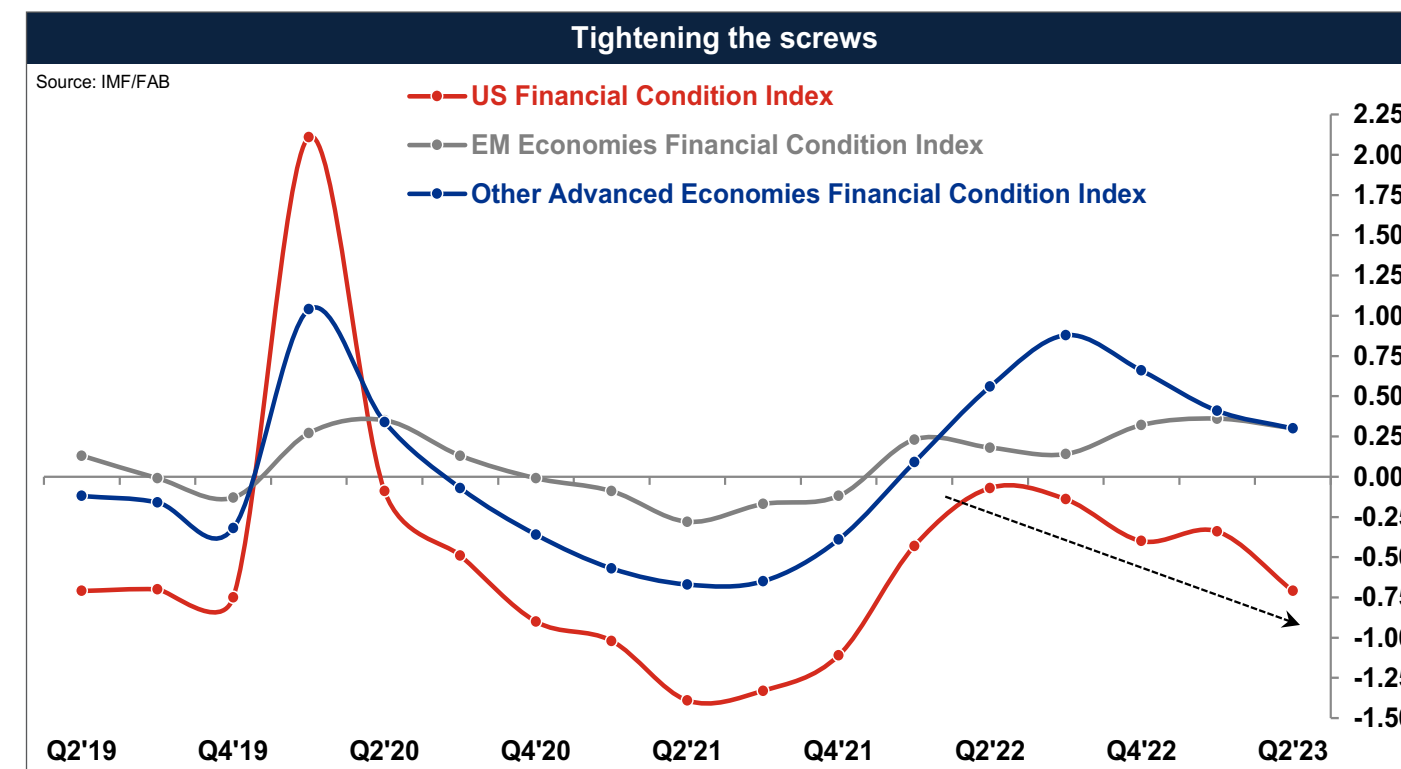


This said, macro indicators are looking increasingly fragile, thereby seeming to advocate a net defensive positioning by investors. Indeed, the International Monetary Fund (IMF) has carefully underscored what is at risk. Back in October last year, in its report

entitled “Navigating Global Divergences”, the IMF opined that substantial economic recovery on a global scale faces significant challenges over the coming quarters. At that stage, the Fund’s baseline outlook suggested a slowdown in global growth

from 3.5% in 2022, to 3.0% in 2023, and then further consolidation this year to 2.9% global real economic

GDP growth; well below the historical average of 3.8% achieved between 2000 and 2019.



While tighter – and tightening – financial conditions are already weighing on economic activity dynamics, we expect them to continue to do so over the coming quarters. Perhaps one of the greatest threats to the global macro horizon would be a re-ignition of inflationary pressures and by extension a shift back to a more hawkish rates position. Our base case scenario remains that the monetary policy tightening process has now run its course and the next move in rates later this year will be to the downside.

Between now and then though we expect rates to remain high, as a reflection of sticky inflation and robust labour market conditions. In order to break the price spiral though and to wrest eventual control of inflation, central banks may be obliged to instigate a modest period of recession. Therein perhaps lies the biggest challenge for central banks in recent history,

We are cognizant that a non-zero probability risk this year is that inflation pressures could re-accelerate, which in turn could encourage central banks to begin turning the monetary tightening screws again. Of course, the impact of such a move toward higher rather than a lower rates structure, could trigger a self-fulfilling negative chain of events that would eventually result in a global recession.

The risk in doing so though may present monetary authorities with their very own ‘Italian Job’ moment. Tasked with delicately dismantling inflation pressures, central banks traditionally only know they have done enough – in either direction – once they have done too much. In such a scenario and in the words of Sir Michael Caine, they could end up blowing a lot more than just the “bl**dy doors off”!

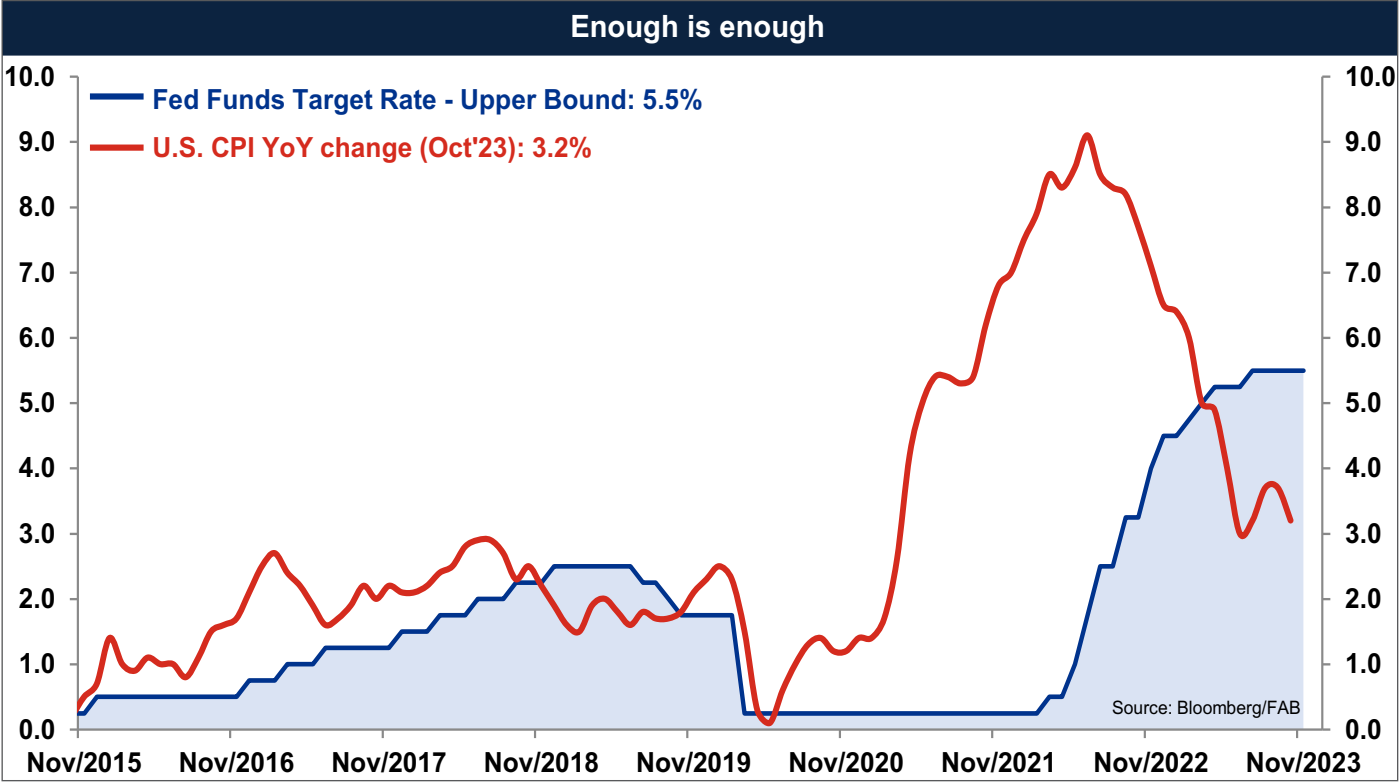


U.S. Macro / Rates

In the context of the recent softening of U.S. economic metrics, all under the confines of restrictive monetary policy and subsequently tighter financial conditions, there is an increasing degree of sympathy with the view that the Federal Reserve reached its peak terminal interest rate in Q4 last year. This of course was a highly contentious issue throughout much of 2023 as the Federal Reserve – and other central banks around the globe – grappled with inflation pressures while only having the relatively blunt tool of monetary policy at their disposal. Indeed, the structural and interest rate insensitive nature of recent inflationary pressures has suggested consistently over the past couple of years that price pressures would remain

sticky and elevated regardless of the absolute level of interest rates.

Price pressures have eased since then, at least optically, as the year-on-year basis has turned more favourable, but inflation remains structurally higher than it was pre-pandemic. In terms of the latter, it is clear that the parameters of price pressures have shifted significantly in the past few years – China disruption to supply chain dynamics and its subsequent anemic reopening, geopolitical impact on food and energy prices etc., so we would argue that it is now unreasonable – other than in the case of protracted recession – for policymakers to be chasing an imminent return to the 2% inflation targets of yesteryear.



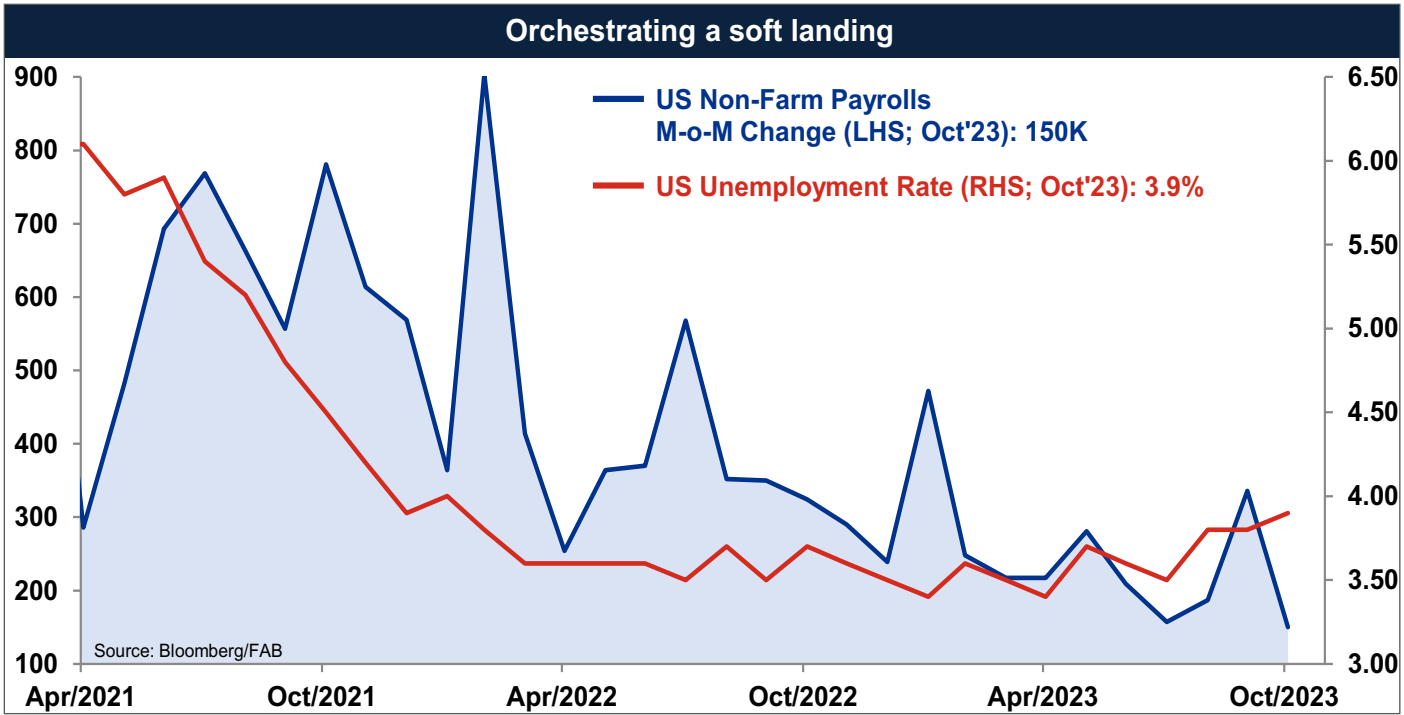
Thus, even as inflation recedes from the recent historic highs though, central banks should now refrain from aggressively chasing the 2% inflation target. Conversely it appears unrealistic to us to expect the Fed (and others) to formally increase their inflation goals at this stage. What is perhaps more likely is that policymakers will adopt and align themselves with a subliminal message of greater tolerance of higher (>2%) inflation for the foreseeable future. This

unwritten flexibility could perhaps see policy being flexed to stomach average inflation closer to 3% territory over the coming months.

Meanwhile though, there has been an increasing recognition during the rate tightening cycle that perhaps the only sure-fire way of wresting control of inflation was to break the economic cycle by driving economies into recession. A look at the

shape of the U.S. Treasury curve is a clear reminder of what is at risk. While the curve has re-steepened of late as further rate tightening expectations have been scaled back, the still inverted nature of the U.S. 2yr/10yr yield curve has been a consistent warning sign of the structural economic damage that would be threatened by raising rates ‘too far’ and leaving them there, in restrictive territory, for ‘too long’.

The Federal Reserve tightened rates by 525 basis points (bps) between March 2022 and July 2023, as a result of which it remains our view that the U.S. economy could enter mild recessionary conditions as we head further into 2024. That is assuming that economy is not in (technical) recession already. That said, we are hopeful that as the Fed now eases its foot off the tightening pedal it will be able to orchestrate a soft-landing outcome for the coming months.



Optimists will argue that the stars have been looking increasingly aligned in recent months for the U.S. economy to experience a soft-landing. The latter has certainly been suggested by the recent resilience in U.S. retail sales and labour market data as well as easing price pressures such as PPI data.

U.S. labour market data for November last year surprised on the upside both in terms of a resilient nonfarm payrolls numbers and a surprise decline in the unemployment rate. In aggregate, the report supported what we have hoped for some time now will prove to be a ‘soft landing’ for the U.S. economy. Furthermore, the data helped to push back against 1H2024 Fed rate cut expectations; something we have argued in recent months have been too dovish.

And to add further weight to the notion that global rates have now peaked, across the pond we have witnessed a sharp fall in UK inflation readings. Some have gone so far as to label current macro conditions as ‘Goldilocks-like’.

The FOMC increased the fed funds target rate to 5.25% - 5.50% in July of last year and has held this rate steady at that level at subsequent policy meetings. As the macroeconomic horizon begins to look more uncertain, if not weaker, the question is no longer how much further the Fed will tighten rates, but when it will pivot and begin unwinding the tightening process.

At the very least, as macro conditions soften, so we expect the Federal Reserve to dial down its hawkish rhetoric, although we are cognizant of the risk that financial conditions could quickly loosen again –



which in turn would likely drive a collapse in rates (treasury yields) and propel risk assets higher.

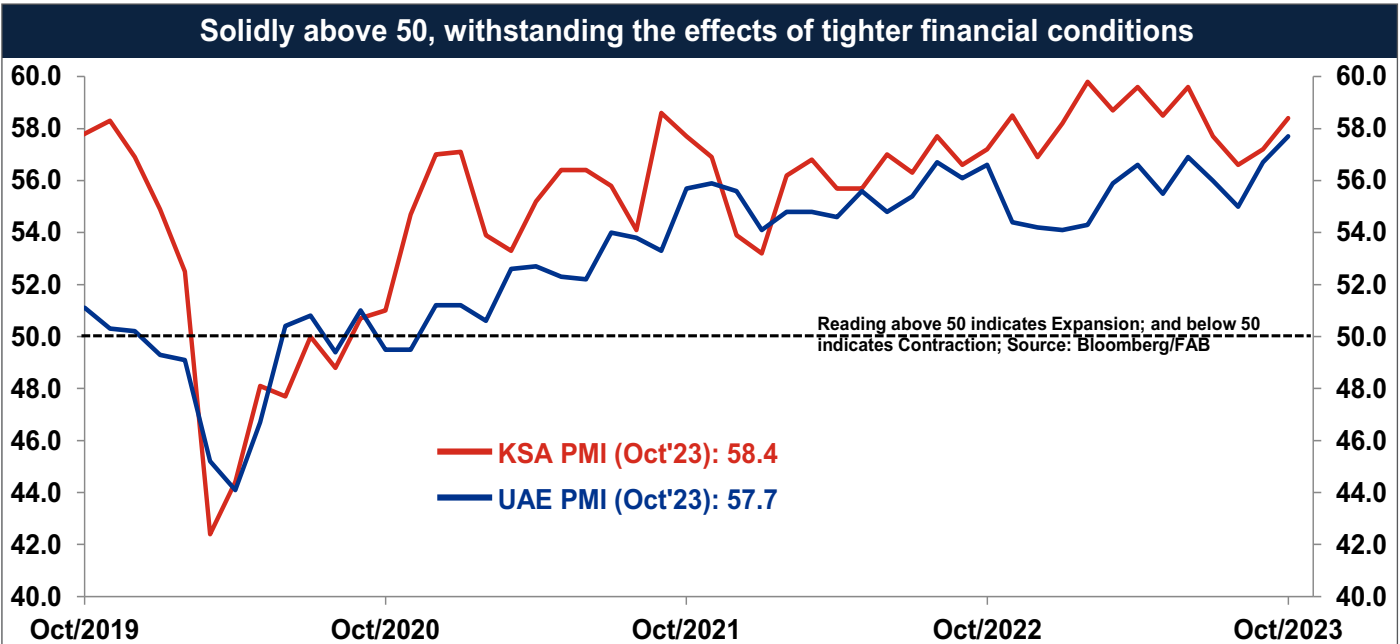
Of course, this was the case throughout much of the latter months of last year (2023). During November and December, we witnessed often rapid price appreciation across treasuries, bonds, equities and credit, all largely buoyed by growing optimism that with economic growth and inflation measures cooling the Fed and other central banks have now hopefully reached the end of their respective rate tightening cycles.

Caveat emptor, if financial conditions were to ease too much then the Fed may need to crank up the tightening mechanism again. It remains our base case scenario that any rate reduction will not emerge until (well into) the second half of this year (2024). That

said we do anticipate that the FOMC will be back in easing mode by Q3 and that it will have trimmed as much as 75 bps off the fed funds rate by December, with further gradual easing (-50 bps) to follow in 2025.

GCC Macro / Rates

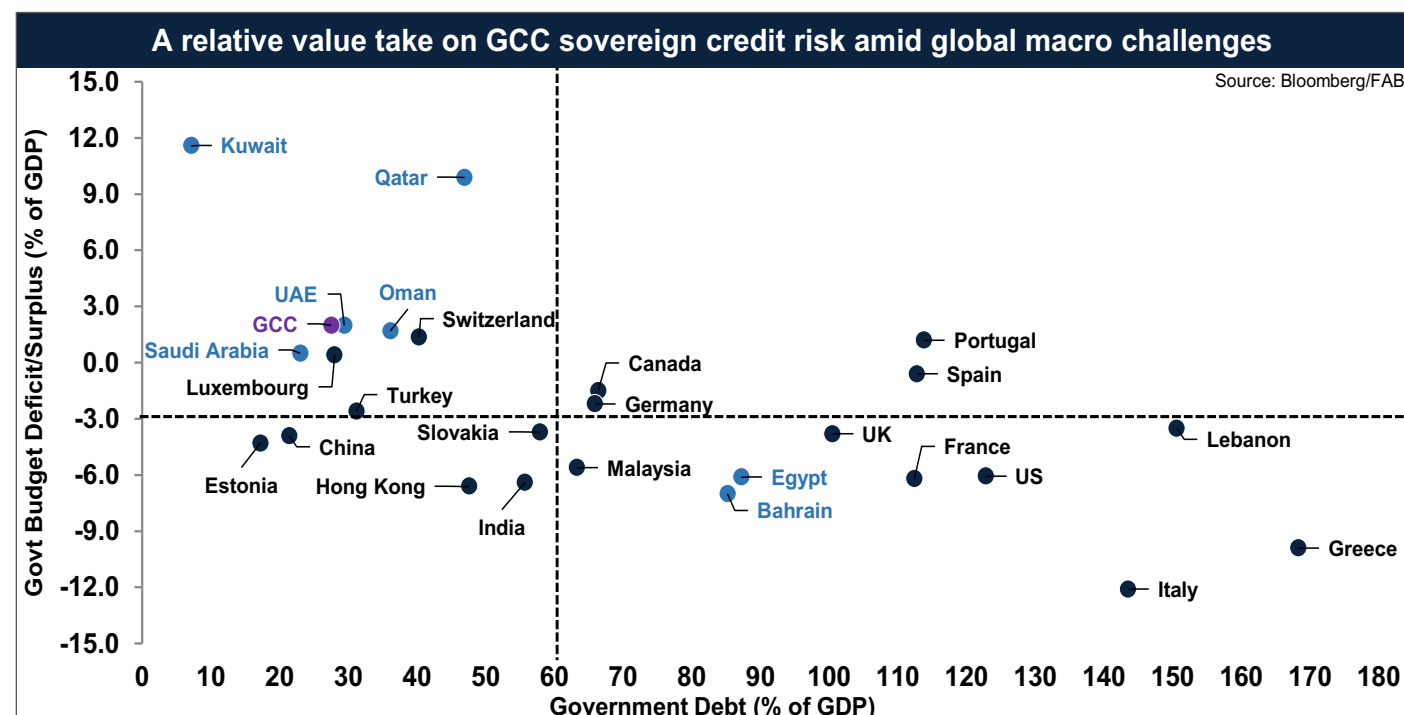
After the slowdown in economic activity levels seen across much of the oil producing Middle East region in 2023, driven by most members’ adherence to the OPEC+ agreed oil production restrictions, the outlook for economic growth potential among the Gulf Cooperation Council (GCC) countries this year (2024) looks a lot more optimistic. We expect the GCC to experience economic growth of around 3.4% this year up from 2.5% in 2023, albeit still well down from the stellar GCC growth rate of 7.3% seen back in 2022.





That said, we believe that it is the GCC's economic robustness and resilience that will set the region apart from the more challenging economic landscape – and restrictive financial conditions – of the U.S. and Europe. In terms of economic growth alone, we anticipate that real GDP growth in the GCC – especially in the United Arab Emirates and the Kingdom of Saudi Arabia – will easily outperform its developed market peers.

Moreover, this relative (GCC) economic strength should also provide the engine of growth for the broader MENA region. Indeed, we expect that MENA-wide region to experience positive growth trends this year (2024) of around 3.2% in aggregate, thereby outperforming the 2.7% average growth rate seen over the 2015-19 period. GCC performance will help to offset the slowdown in the economies of the Levant region.



That said, there is much fundamental sovereign credit variation between the varying GCC member states, with the UAE and Saudi Arabia offering the strongest credit quality. Conversely, Bahrain and Oman offer the weakest (but also often highest yielding from an investment perspective) fundamentals as far as their public debt, structural fiscal weaknesses and lesser absolute level of oil reserves are concerned.

As a consequence of their USD-pegged currency regimes, we expect rates across the Gulf Cooperation Council (GCC) to largely track, like-for-like, those of the U.S. through any (downward) variations during 2024. Just as they did during the tightening process of 2023.

Euro Area Macro / Rates

As we enter 2024, the macroeconomic outlook for the Euro area appears to be even more fragile than that for the U.S. That said after anemic economic growth last year in 2023, when the regional economies were weighted down by historically elevated inflation levels, tighter financial conditions amid rising interest

rates, as well as weak external demand, the Euro area economy will hopefully see the return of some positive economic momentum this year.

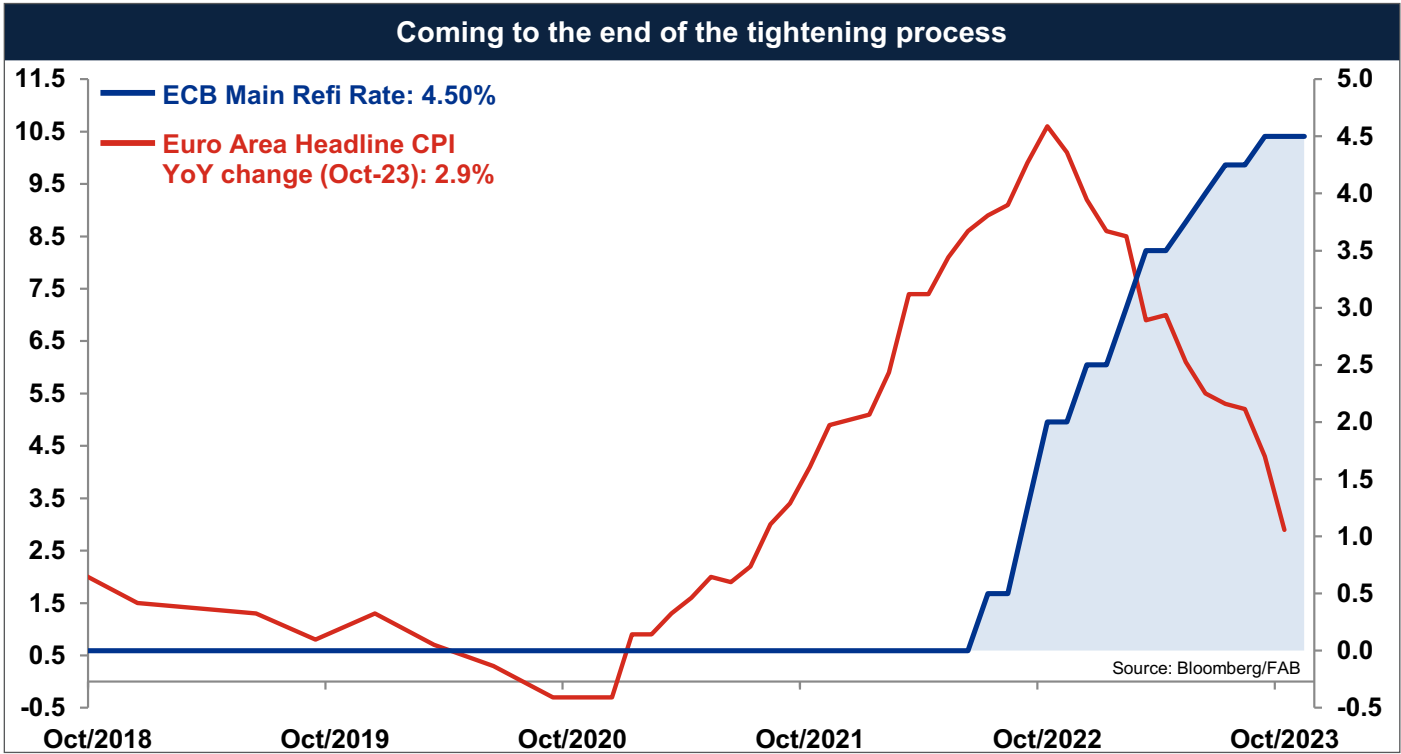
When the final data emerges, we expect economic growth across the Euro area in 2023 to have been anchored at, if not just below, 0.6%. We then anticipate economic activity across the 20-country region to rebound modestly this year (FY 2024) to around a +1.1% growth rate; albeit still well short of the consolidating growth rate that we anticipate for the United Arab Emirates this year (+4.0%).

Moreover, our forecast for Eurozone real GDP growth this year is marginally lower than that of the European Commission itself (+1.2%) to reflect what we believe will be the ECB's continued, blinkered, one-dimensional mandate and focus on price stability. With inflation likely to stay sticky, well above the ECB's established 2% inflation target, over the coming months, we see the risk that the ECB will retain an outright hawkish bias to monetary policy at least until the midpoint of the year, all of which will likely be a choke on economic performance.



But the latter is already under pressure. Euro area GDP fell in 3Q2023 and the region's composite PMI was languishing at 46.5 at the last count, having

been sub-50 since June of last year (2023). Eurozone manufacturing PMI looks even more soft, sitting down at 43.1 and drowning sub-50 since July 2022.



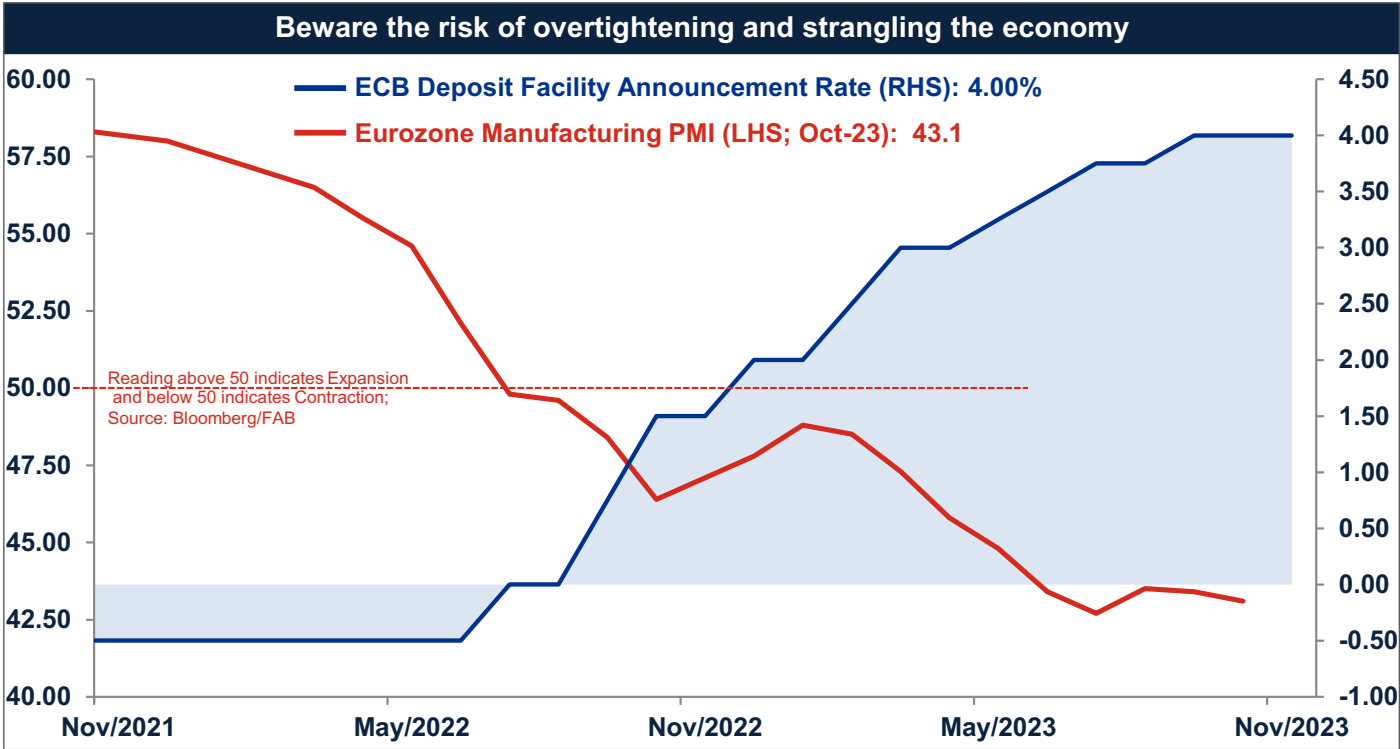
Consequently, we expect such weakening macro conditions to put the European Central Bank into monetary easing mode sooner than the Fed. At the very least it should reassure markets that the ECB is now firmly in peak rates territory. In fact, the ECB warned of such an outcome at a recent policy meeting when it stated that 'interest rates are at (now) levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal (of returning to its 2% inflation target).

Without doubt, the evidence is building that Eurozone monetary policy is now restrictive, perhaps even highly restrictive. In this respect we note that (M3) money supply is contracting, and Euro area credit growth is stalling. And as credit standards tighten loan demand collapses. The bottom line is that the Eurozone will flirt with the brink of recession as we move further into 2024.



So, assuming we are kicking off 2024 with the ECB's policy rate at its peak, as the economy weakens and inflation recedes, we believe the backdrop should prove supportive for core eurozone government bonds versus peripheral debt. The latter of course tend to rally against core (Germany) debt during positive economic conditions, while we tend to see peripheral spreads over Germany widen as economic conditions deteriorate and a more risk averse sentiment grips the market.

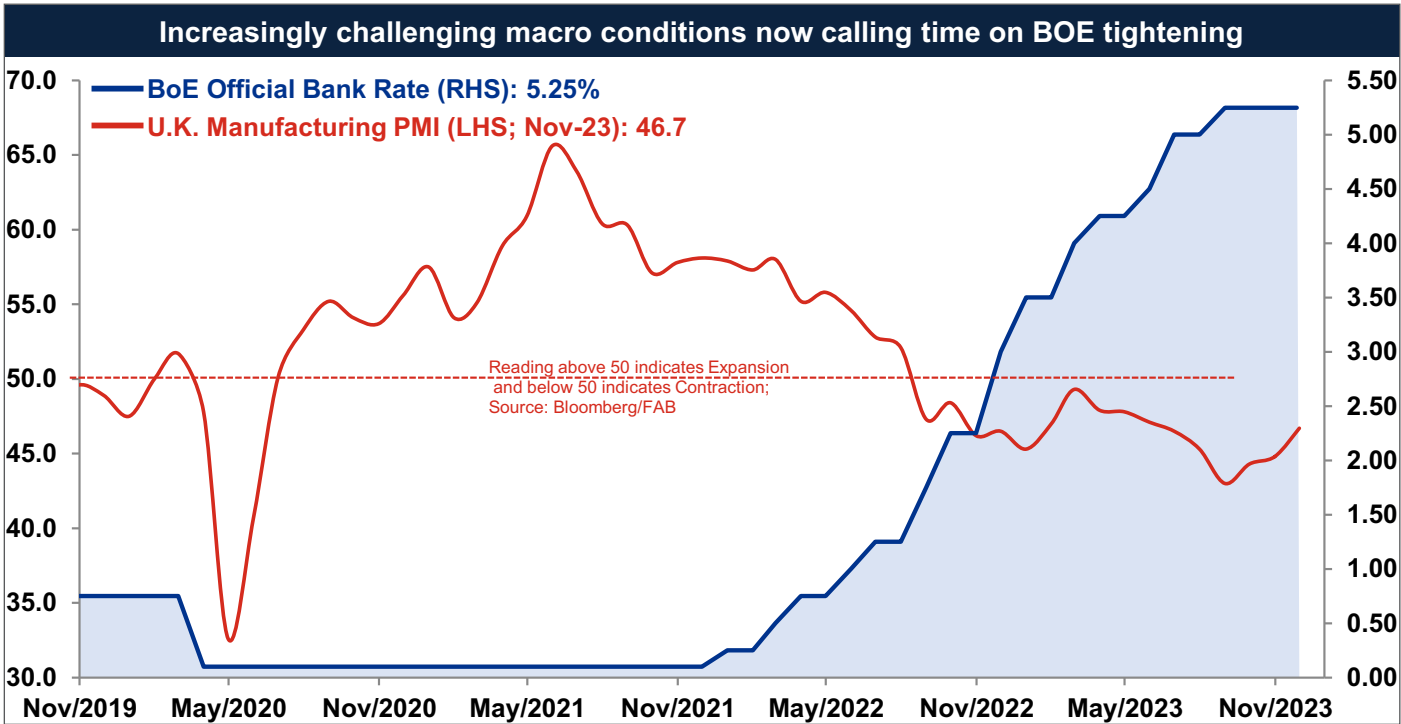
With Italy perhaps looking particularly fragile amongst its peripheral peers at this stage of the macro story, BTP-Bund (Italian Government bond – German Government Bond) spread widening could be a key theme in this part of the world as this year progresses. And meanwhile, the euro could also underperform until U.S. growth cools meaningfully and the Fed makes the dovish pivot alluded to earlier.



UK Macro / Rates

While concerns and fears of an imminent and painful recession by the UK have gradually dissipated in recent months, it is clear that the UK economy is far from facing a clean bill of health. Nor is it likely to be given one any time soon. The combination of weak growth, sticky, elevated inflation and bulging government debt all adds up to paint a picture of a tough and challenging macro-outlook for the UK economy over the next twelve months.

Moreover, not only would we conjecture that the UK economy currently exhibits all the characteristics of a stagflationary environment, but in our view, we would also contend that the balance of risk for the UK economic outlook in 2024 remains firmly skewed to the downside. Add in a general election and the prospects for a bumpy ride for investors seem even more likely. Buckle up!



After what should prove to have been weak GDP growth of just 0.4% last year (2023), this year the UK economy is set to look even more sickly. We anticipate UK real GDP growth of a more modest 0.3% magnitude this year (2024).

Under the shackles of restrictive financial conditions and high interest rates after the 515 bps of rate tightening by the Bank of England between December 2021 (Bank Rate 0.1%) and August 2023 (Bank Rate 5.25%), as well as continued macroeconomic and political uncertainty and low productivity, we continue to see myriad near-term headwinds to UK growth. As alluded to above, the upcoming general election – by the end of the year – in what is rapidly

becoming an increasingly divided political landscape will then add a further layer of complexity to the broader macro-outlook.

This being said, one positive economic element over the coming months could be the resilience of consumer spending and retail sales, supported by wage growth and the protracted easing of labour market conditions. Less encouraging though is the fact that inflation will likely remain elevated for much of this year – for longer and above the level that the Bank of England would feel comfortable with.

The key takeaway from this scenario for the rates market therefore, must be that Bank Rate will stay ‘high for longer’, but not necessarily ‘higher for



longer’. There is significant difference. Nonetheless, we now expect the ‘plateau’ of higher interest rates to extend until well into the second half of the year (2H2024), before dropping significantly in 2025 as economic conditions implode.

Conclusion

Whereas last year marked central banks’ arrival at the pinnacle of the latest rate tightening cycle – a cycle that has seen mainstream U.S. and European interest rates tightened by 500 bps on average over the past 2 years – this year should be the year of plateauing rates. At least for the first half of the year.

Optimists will argue that the stars have been looking increasingly aligned in recent months for the U.S. economy to experience a soft-landing. The latter has certainly been suggested by the recent resilience in U.S. retail sales data as well as easing price pressures such as PPI data. In fact, some have gone so far as to label current macro conditions as Goldilocks-like.

In our opinion, with rates having peaked, the next moves by the Fed, the ECB and the BoE will all be down. The bigger questions are when, by how much and how quickly?

Amid tighter, and still tightening, financial conditions, monetary policymakers will now be cognizant of the need to cushion their respective economies against the downside risk of slowing economic growth. At the same time though the sticky resilience of elevated inflation pressures will create a degree of complexity and challenge to setting the most appropriate direction of rates policy.

Allow financial conditions to loosen too rapidly and the inflation genie could be let out of the bottle again; the bottle that has proved so difficult to get the genie back into in the first place. For this reason alone, we feel that current futures market pricing of the first full (25 bps) rate cut by the Federal Open Market Committee (FOMC) coming as early as May, and for an aggregate 100 bps of easing by year-end is probably too dovish. We currently anticipate a later (Q3) start and an aggregate tightening of 50 bps-75 bps, with further gradual easing (-50 bps) to follow in 2025.

On the flip side though, maintain a hawkish bias for too long and the unintended consequence could be a deep and painful recession. This really does now come down to fine tuning.