Market Insights & Strategy

Please click **here** to view our recent publications on MENA and Global Markets

Your attention is drawn to the important notice on the final page of this communication

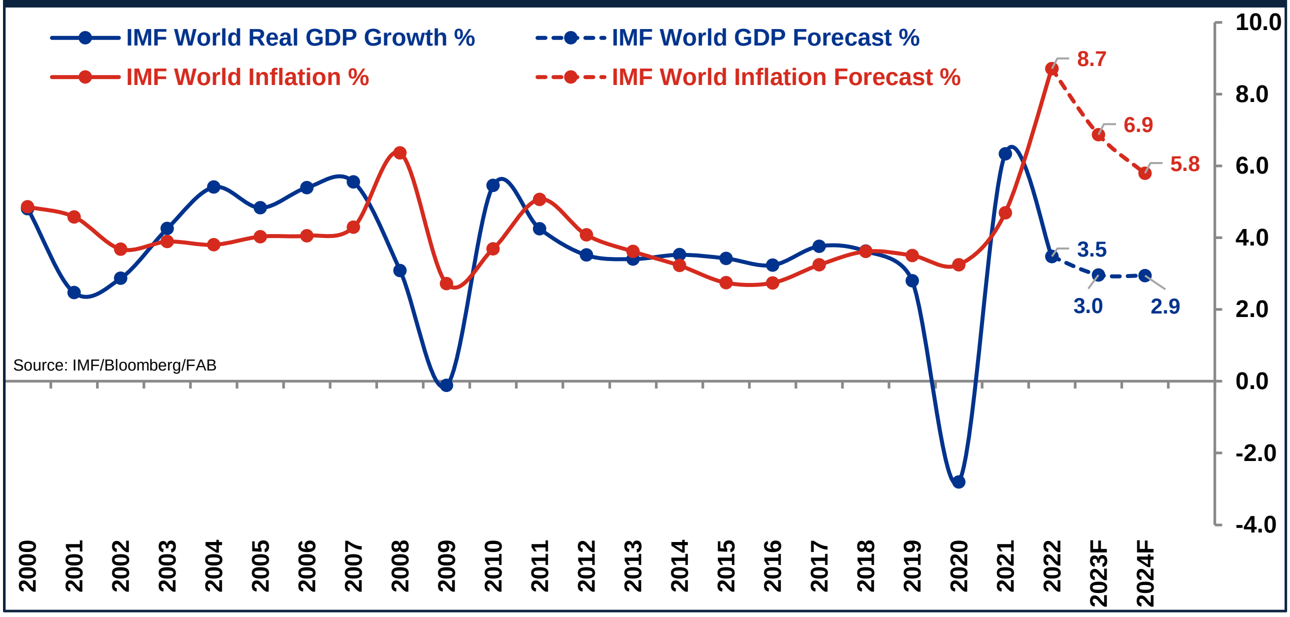
Simon Ballard
Chief Economist

A Global Macro Rates Perspective on 2024: View from the Plateau

As we hurtle toward 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.

Macro uncertainty and the ever-present specter of recession across much of Europe and the U.S. will likely act as a straitjacket for global interest rates over the first half of the coming 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 next year.

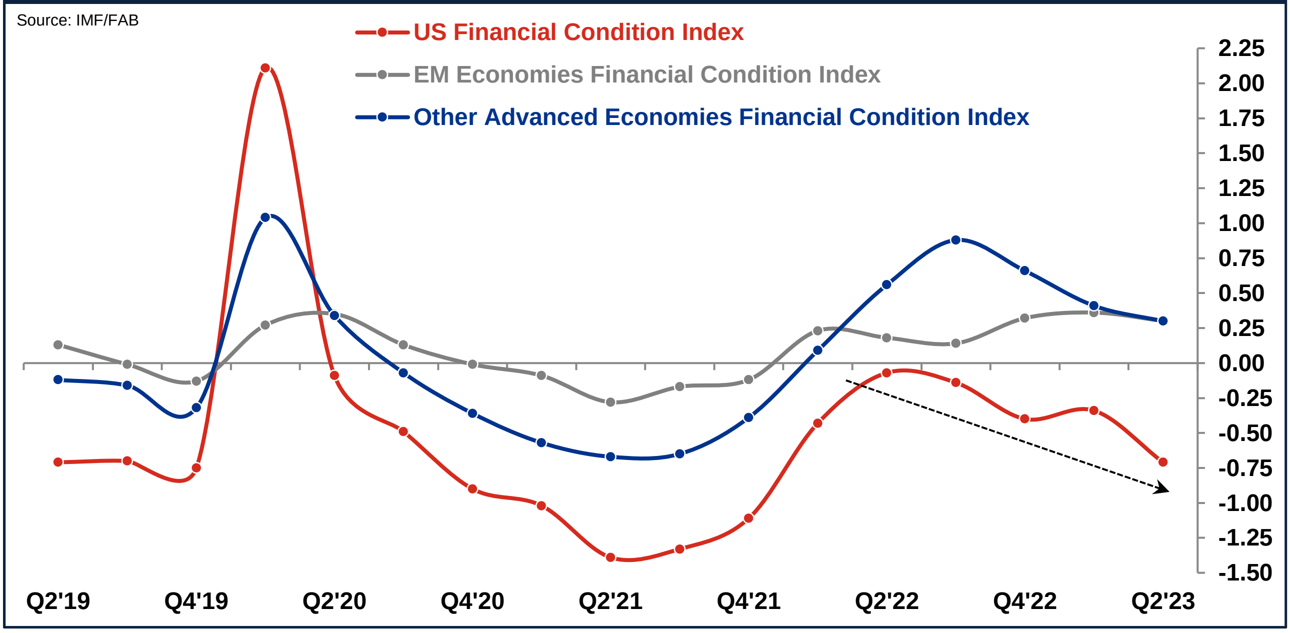
What goes up must come down, must go up…



Source: IMF/Bloomberg/FAB

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 this 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 next year in 2024 to 2.9% global real economic GDP growth; well below the historical average of 3.8% achieved between 2000 and 2019.

Tightening the screws



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, which we believe could result from a premature shift back to an easing bias. In turn, this would then necessitate 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 next year will be to the downside.

Between now and then though we expect rates to remain high, as a reflection of sticky inflation. 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 next year will be 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 a 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"!

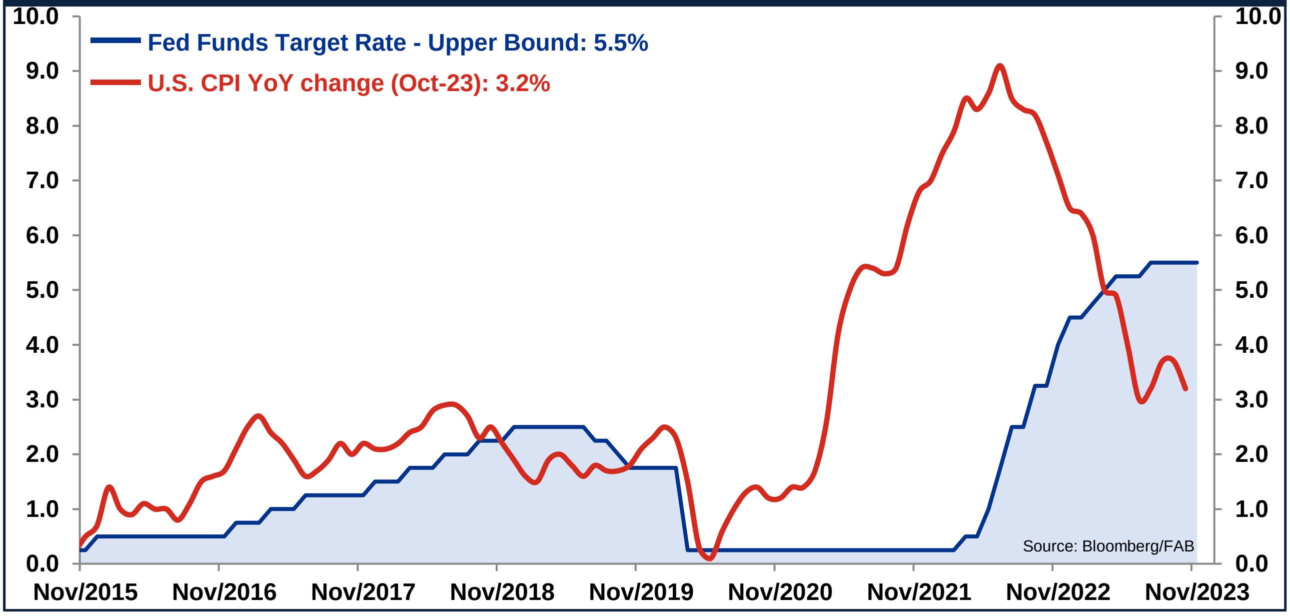
Continued…

U.S. Macro / Rates

In the context of the recent softening of U.S. economic metrics, as evidenced by the recent cooling of labour market and inflation measures – including the encouraging decline in October PCE deflator, the Fed's preferred gauge of inflation – 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 this year. This of course has been 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.

Enough is enough

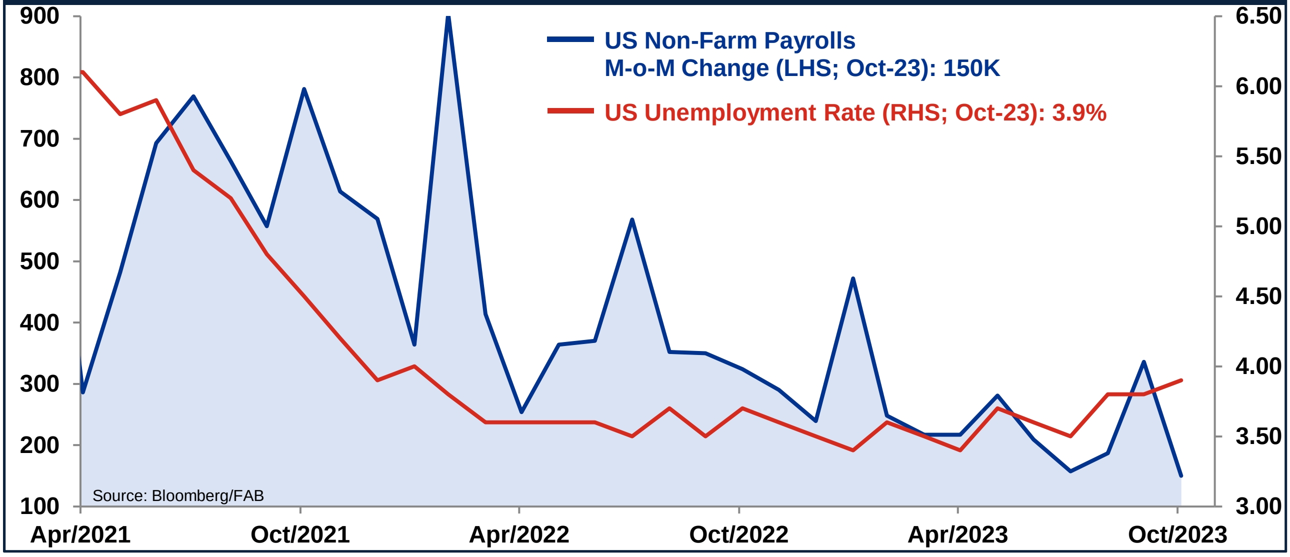


Thus, even as inflation recedes from the recent historic highs though, central banks should now refrain from aggressively countenancing the 2% inflation target. Conversely it appears unrealistic to us to expect the Fed (and others) to formally increase their inflation goals at this stage. What is perhaps 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 and increased optionality 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 marginally 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 525bps 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 into 2024. That is assuming that the economy is not in (technical) recession already. As such, 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 over the coming months.

Orchestrating a soft landing



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.

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 trends in global macro conditions as ‘Goldilocks-like’.

The FOMC increased the fed funds target rate to 5.25%-5.50% in July this 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 further collapse in rates (treasury yields) and propel risk assets higher.

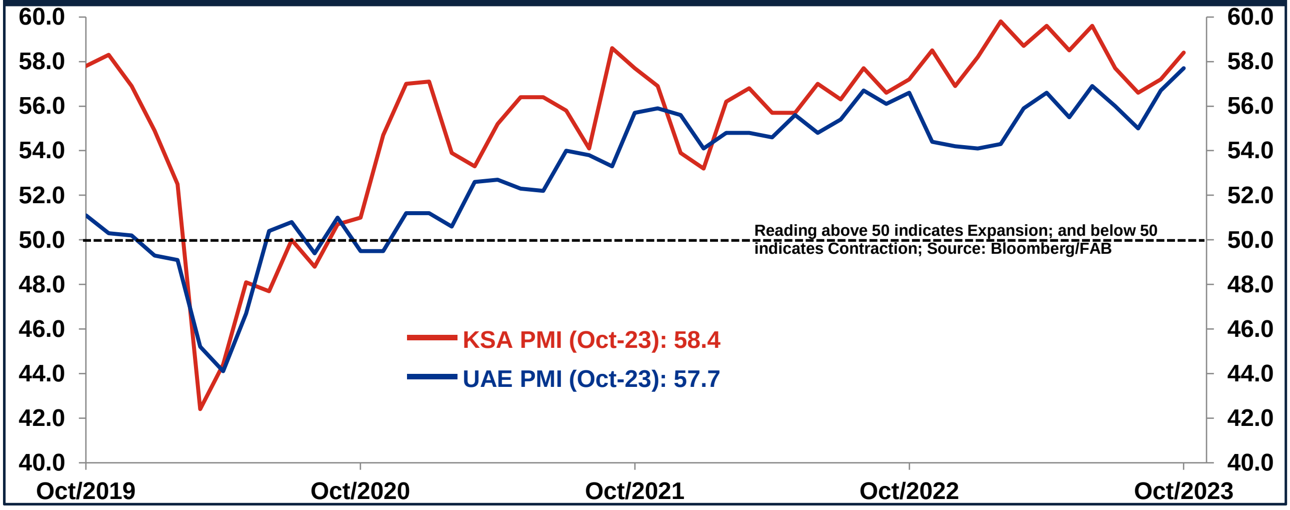
Of course, this has been the case throughout the past month. During November we have witnessed rapid price appreciation across treasuries, bonds, equities and credit, all largely buoyed by growing optimism that with economic growth and inflation measures cooling the Fed and other central banks have hopefully 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 next year (2024). That said we do anticipate that the FOMC will be back in easing mode by 3Q2024 and that it will have trimmed as much as 75bps off the fed funds rate by December next year, with further gradual easing (-50bps) to follow in 2025.

GCC Macro / Rates

After the slowdown in economic activity levels seen across much of the oil producing Middle East region during the course of this past year, 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 next year (2024) looks a lot more optimistic. We expect the GCC to experience economic growth of around 3.4% next year up from 2.5% in 2023, albeit still well down from the stellar GCC growth rate of 7.3% seen back in 2022.

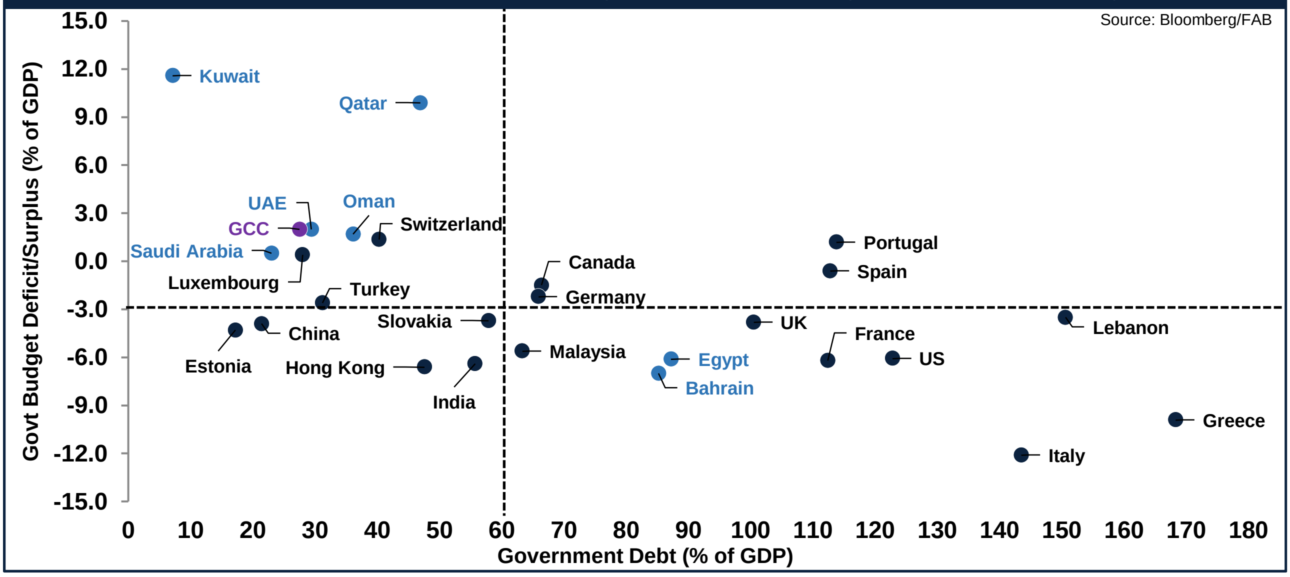
Solidly above 50, withstanding the effects of tighter financial conditions



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 next 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.

A relative value take on GCC sovereign credit risk amid global macro challenges



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 investment opportunities. 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 position 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 over the past couple of years.

Euro Area Macro / Rates

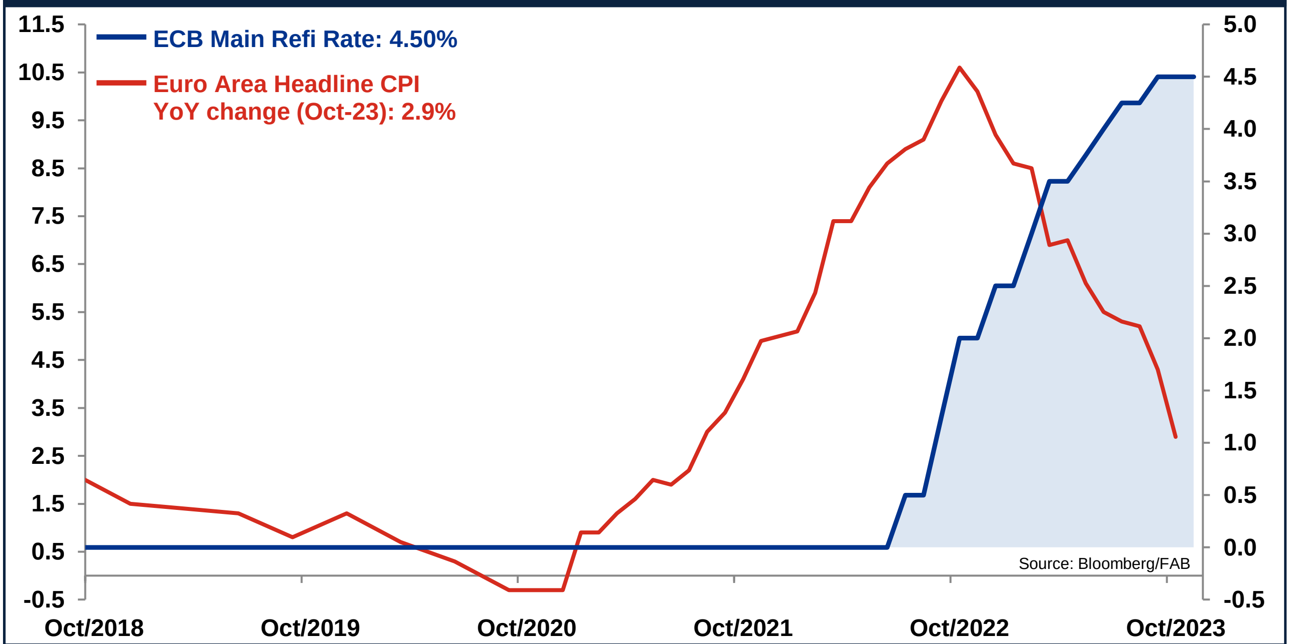
As we head toward 2024, the macroeconomic outlook for the Euro area appears to be even more fragile than that for the U.S. That said after anemic economic growth this year, when the regional economies were weighted down by historically elevated inflation levels, tighter financial conditions amid rising interest rates, as well as weak external demand, the Euro area economy will hopefully see the return of some positive economic momentum next 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 next 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 next year (+4.0%).

Moreover, our forecast for Eurozone real GDP growth next 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 next 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 47.1 at the last count in November, having been sub-50 since June this year. Eurozone manufacturing PMI looks even more pallid, sitting down at 43.8 and drowning sub-50 since July 2022.

Coming to the end of the tightening process



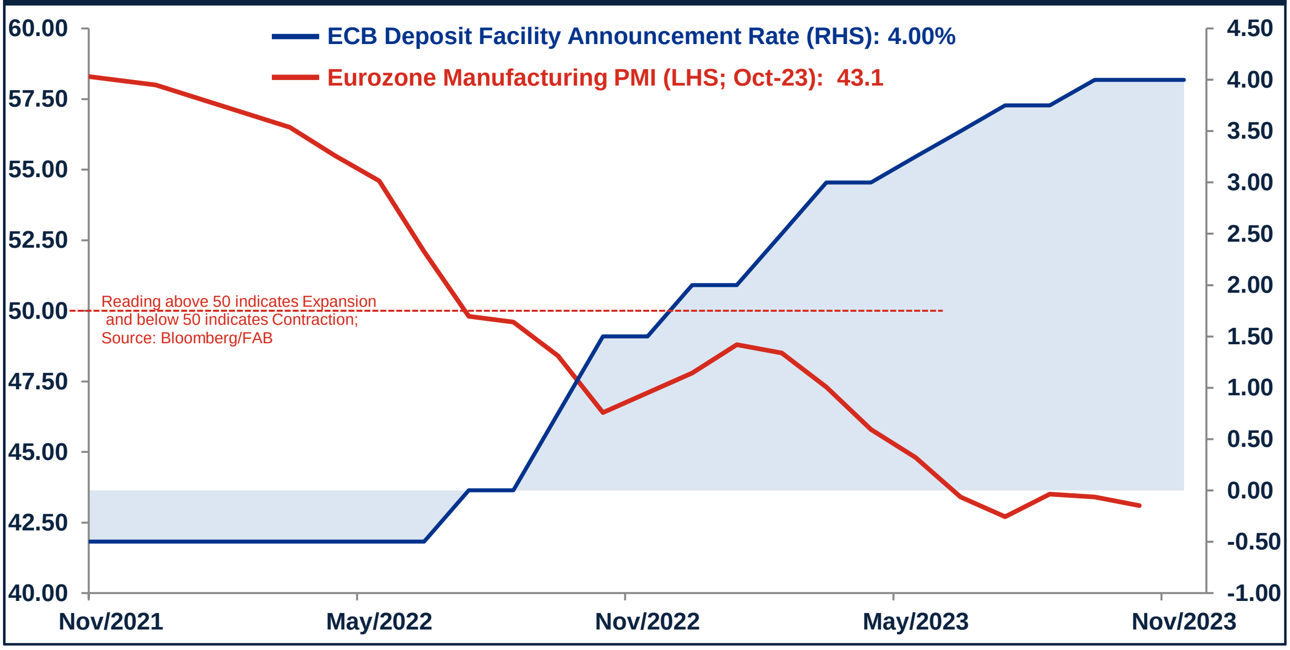
Consequently, we expect such flaccid macro conditions to put the European Central Bank into monetary easing mode sooner than the Fed. At the very least it should reassure markets that the ECB is now firmly in peak rates territory. In fact, the ECB warned of such an outcome at a recent policy meeting 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 is also collapsing. The bottom line is that the Eurozone will flirt with the brink of recession as we move into 2024.

So, assuming we will kick 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 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 spread widening could be a key theme in this part of the world as next 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.

Beware the risk of overtightening and strangling the economy



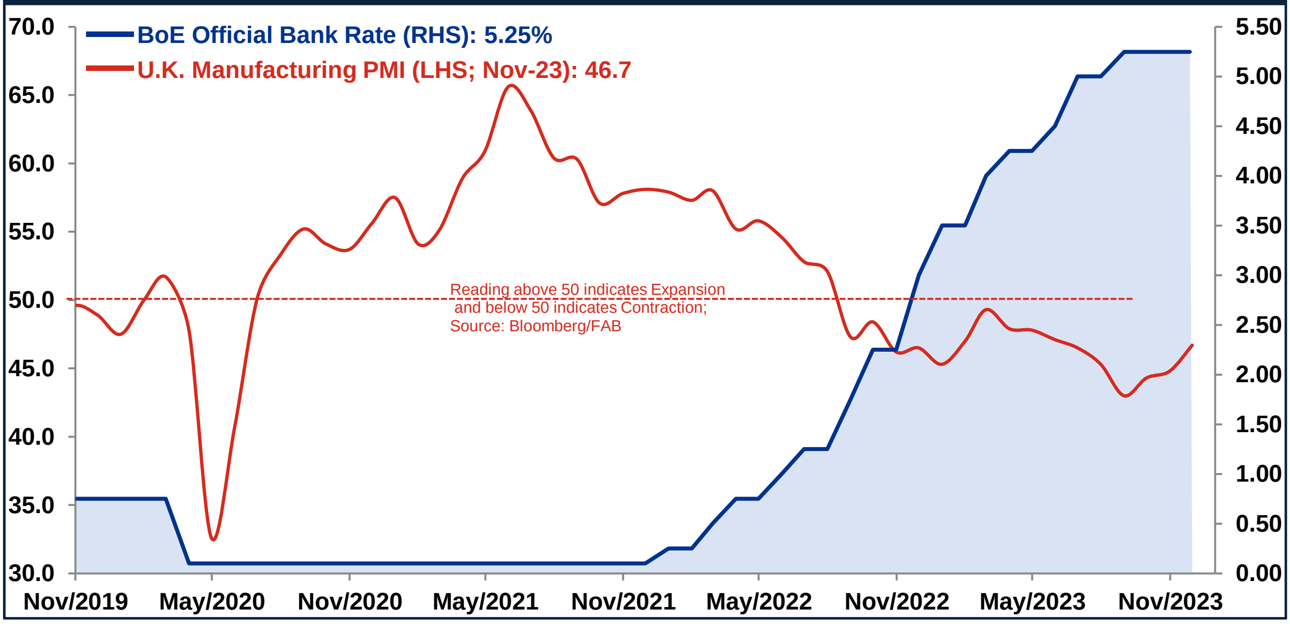
Continued…

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 amid increased market volatility seem even more likely. Buckle up!

Increasingly challenging macro conditions now calling time on BOE tightening



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

Under the shackles of restrictive financial conditions and high interest rates, after the 515bps 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 next year – in what is rapidly becoming an increasingly divided and polarized 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 next 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 next year (2H2024), before dropping significantly in 2025 as economic conditions implode.

Conclusion

Whereas this year has 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 500bps on average over the past 2 years – 2024 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 (global) 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 genie that is still proving so difficult to get back into the bottle in first place. 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.

Simon Ballard
Chief Economist
Market Insight & Strategy
FAB Global Markets
Please click here to view our recent publications on MENA and Global Markets

sources believed to be reliable, it may be incomplete or condensed, it has not been verified by FAB and its accuracy cannot be guaranteed. FAB makes no representation or warranty, expressed or implied, as to the accuracy of the information, the reasonableness of any assumptions used in calculating any illustrative performance information or the accuracy (mathematical or otherwise) or validity of such information. Any opinions attributed to FAB constitute FAB's judgment as of the date of the relevant material and are subject to change without notice. Provision of information may cease at any time without reason or notice being given. Commissions and other costs relating to any dealing in any products or entering into any transactions referred to in this communication may not have been taken into consideration. Any scenario analysis or information generated from a model is for illustrative purposes only. Where the communication contains "forward-looking" information, such information may include, but is not limited to, projections, forecasts or estimates of cashflows, yields or return, scenario analyses and proposed or expected portfolio composition. Any forward-looking information is based upon certain assumptions about future events or conditions and is intended only to illustrate hypothetical results under those assumptions (not all of which are specified herein or can be ascertained at this time). It does not represent actual termination or unwind prices that may be available to you or the actual performance of any products and neither does it present all possible outcomes or describe all factors that may affect the value of any applicable investment or product. Actual events or conditions are unlikely to be consistent with, and may differ significantly from, those assumed. FAB shall not be under an obligation to update any information contained in this communication. Illustrative performance results may be based on mathematical models that calculate those results by using inputs that are based on assumptions about a variety of future conditions and events and not all relevant events or conditions may have been considered in developing such assumptions. Accordingly, actual results may vary and the variations may be substantial. The products or transactions identified in any of the illustrative calculations presented herein may therefore not perform as described and actual performance may differ, and may differ substantially, from those illustrated in this communication. When evaluating any forward looking information you should understand the assumptions used and, together with your independent advisors, consider whether they are appropriate for your purposes. You should also note that the models used in any analysis may be proprietary, making the results difficult or impossible for any third party to reproduce. This communication is not intended to predict any future events. Past performance is not indicative of future performance. FAB accepts no responsibility and makes no representation to you or to any third parties for, and has not independently verified, the quality, accuracy, timeliness, continued availability or completeness of any data or calculations contained and/or referred to in this communication and FAB shall not be liable for any special, direct, indirect, incidental or consequential loss or damage which may be sustained because of the use of the information contained and/or referred to in this communication or otherwise arising in connection with the information contained and/or referred to in this communication, provided that this exclusion of liability shall not exclude or limit any liability under any law or regulation applicable to FAB that may not be excluded or restricted. The transactions and any products described herein may be subject to fluctuations of their mark-to-market price or value and such fluctuations may, depending on the type of product or security and the financial environment, be substantial. Where a product or transaction provides for payments linked to or derived from prices or yields of, without limitation, one or more securities, other instruments, indices, rates, assets or foreign currencies, such provisions may result in negative fluctuations in the value of and amounts payable with respect to such product prior to or at redemption. You should consider the implications of such fluctuations with your independent advisers. The products or transactions referred to in this communication may be subject to the risk of loss of some or all of your investment, for instance (and the examples set out below are not exhaustive), as a result of fluctuations in price or value of the product or transaction or a lack of liquidity in the market or the risk that your counterparty or any guarantor fails to perform its obligations or, if this the product or transaction is linked to the credit of one or more entities, any change to the creditworthiness of the credit of any of those entities. FAB (whether through the individual sales and/trading personnel involved in the preparation or issuance of this communication or otherwise) may from time to time have long or short principal positions and/or actively trade, for its own account and those of its customers, by making markets to its clients, in products identical to or economically related to the products or transactions referred to in this communication. FAB may also undertake hedging transactions related to the initiation or termination of a product or transaction, that may adversely affect the market price, rate, index or other market factor(s) underlying the product or transaction and consequently its value. FAB may have an investment banking or other commercial relationship with and access to information from the issuer(s) of securities, products, or other interests underlying a product or transaction. FAB may also have potential conflicts of interest due to the present or future relationships between FAB and any asset underlying the product or transaction, any collateral manager, any reference obligations or any reference entity. Any decision to purchase any product or enter into any transaction referred to in this communication should be based upon the information contained in any associated offering document if one is available (including any risk factors or investment considerations mentioned therein) and/or the terms of any agreement. Any securities which are the subject of this communication have not been and will not be registered under the United States Securities Act of 1933 as amended (the Securities Act) or any United States securities law, and may not be offered or sold within the United States or to, or for the account or benefit of, any US person, except pursuant to an exemption from, or in a product or transaction, not subject to, the registration requirements of the Securities Act. This communication is not intended for distribution to, or to be used by, any person or entity in any jurisdiction or country which distribution or use would be contrary to law or regulation. FAB may process your personal data to provide you with information or promotional and advertising communications on products, services, other events and campaigns.

If you wish not to receive email from the Market Insights team at FAB, please click here to send us your request to unsubscribe, and you shall no longer receive such information. You can also let us know by contacting your usual FAB representative should you wish to no longer receive any such further information. You may be entitled according to the applicable laws to exercise your rights to access, to rectification, to erasure and to portability of your personal data, to restrict the use of and to object to the processing of your personal data. You may exercise any such aforesaid rights by sending your request to FAB at the following address: privacy@bankfab.com.