Fixed Income Insights

Macro Talking Points

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In brief

- **The Fed is likely to cut rates, but the key question is what happens next.**
- **Fiscal credibility matters when assessing sovereign risk. Just look at the UK.**
- **EM as an asset class is potentially in the line of fire after the US election.**

FOMC: Fear of Missing Cuts. Following some hints of hawkishness over the past couple of weeks, there has been mounting nervousness about whether the US Federal Reserve would cut rates at all this month. But as stressed by our chief economist, Erik Weisman, a 25-basis point move is now virtually a done deal. The soft nonfarm payroll print released on Friday, albeit made confusing by the impact of storms and strikes, may have helped remove the last soupçon of investor anxiety. This week's FOMC is nonetheless going to be a high-risk communications exercise because it is likely to involve a change in the pace of easing. Of course, the Fed will hide behind the proverbial "we are highly data-dependent", but that hasn't prevented them from communications mishaps in the past. How they will explain the move down from 50 bps to 25 bps is going to be particularly interesting. Likewise, in Erik's view, one critical question going forward is whether the Fed could skip a rate cut in December altogether. In other words, would the data-dependency stretch all the way to an intermittent easing cycle? If there are hints dropped in that direction, we then anticipate rates would correct further to the upside, while rate volatility would continue to climb. At this juncture, the federal funds curve has priced out some future easing in a substantial way. When looking at the federal funds future pricing for July 2025, the current estimate is some 86 bps higher than it was in mid-September.[1] In other words, more than three full rate cuts have been priced out in just six weeks. At least, the bar is now quite low for the Fed to exceed market expectations for future easing in the period ahead.

Fiscal credibility matters. When our fixed income investment team assesses sovereign risk across countries, the credibility of fiscal policy is always an important consideration. With that in mind, releasing a new budget is a high-risk communications exercise for most governments. A perceived erosion in fiscal discipline, unless warranted as a response to a growth shock, is usually frowned upon. Similarly, a large pick-up in borrowing has the potential to dent investor sentiment. A substantial increase in government spending — especially when focused on current as opposed to capital expenditure — can also raise questions about the productiveness of government spending. Finally, investors tend to get really nervous when fiscal policy undermines what the central bank is trying to do through its monetary policy. As it turns out, that whole list of investor concerns appears to be applicable to the UK budget that was announced last week. In the process, the 10-year government bond yields have risen by some 15 bps since the budget speech. Our head of developed markets rates research, Peter Goves, is of the view that the local curve should steepen going forward, as higher fiscal risks will likely impact the longer end. At some point, when the dust settles, a buying opportunity may emerge for UK duration, but it is probably too early to make that call.

Big and binary. Every single global investor is likely to watch the outcome of the US election very closely, given its likely significant impact on global markets. Ironically, the result will likely impact emerging markets fixed income more than US markets: The result could trigger a strengthening of the US dollar and a further rise in US rates in the event of a Trump win. If that scenario were to materialize, two major headwinds for EM as an asset class would likely resurface. Under a Republican win, stronger US growth and looser fiscal policy could re-start US exceptionalism, pushing US interest rates higher. In addition, there is the added risk of trade war escalation, which would also be a headwind for EM. The good news is that these risks have been partly priced in already. It looks very binary to us: a relief rally or further correction? All eyes are on the US for the answer.

Endnotes

[1] Source: Bloomberg. Based on the federal funds future curve. Data as of 1 Nov. 2024.

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