Market View
Prospects for rate cuts in 2024

Equity and bond markets posted strong rallies over the final three months of the year, marking a turnaround from the three previous disappointing quarters.

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Author Jeremy Sterngold

The market viewed recent inflation data and dovish central bank communication as a signal that rates have peaked and applauded the fact that central banks appear to have successfully orchestrated a soft landing.

This led to equity markets surging in November, a rally that continued in December, with the S&P 500 finishing the fourth quarter up 11.7% and 26.3% for 2023.[1] The equity rally was broad based, with the FTSE 100, the Eurostoxx 600 and Topix up 2.3%, 6.8% and 2% respectively over the fourth quarter in local currency terms.[2]

It's an about turn from a few months ago, when strong growth led to the very real possibility of another rate hike.

Resilient growth in the third quarter aided by a relatively loose fiscal policy meant the US economy shrugged off the Federal Reserve's (Fed's) tightening, with GDP growing at an above trend pace of 5.2% annualised over the third quarter.[3] Economic resilience led to concerns mounting over booming deficits and worries that interest rates would remain higher for longer, which sent ten-year Treasury yields surging to 5% in October for the first time since 2007.[4]

However, as price pressures abated over the fourth quarter, the possibility of more rate hikes faded. Softer economic data, muted price pressures and a weaker labour market boosted confidence that the hiking cycle may well and truly be over. Investors also began rapidly pricing in rate cuts for 2024. The Fed's last meeting showed a dovish pivot with median projection that interest rates will be around 4.5% by year-end 2024, down from current levels of 5.25%. However, following the Treasury market rally in recent weeks, investors now expect an even sharper drop in interest rates, forecasting rates will hover around 4% at the end of 2024. Ten-year Treasury yields retreated to below 4% as a result, cementing a remarkable 1% drop in less than two months.[5]

Commodities were a weak spot in the final three months of the year, as Chinese economic data continued to disappoint. Geopolitical tensions, spurred by the conflict in the Middle East, initially sent oil prices up sharply, though in recent months Brent has retreated sharply to 2023 lows despite further production cuts announced by OPEC+.

As the Fed pivoted, both the Bank of England (BoE) and the European Central Bank (ECB) remained more steadfast in their December meetings. The BoE has the longest uphill battle when it comes to reaching its inflation target, and ideally would like to see wages come down before it considers any rate cuts. Its position is also complicated by potential further fiscal loosening ahead of the next UK general election. Growth is muted and inflation is declining, although inflation remains higher than other developed countries.

Investors have higher conviction that the ECB rate cuts will be forthcoming, with growth in Europe stagnating for months, as the economy flirts with a recession. The headline Eurozone inflation has moved rapidly lower to 2.4%, indicating that growth dynamics may continue to be weak.[6]

On the geopolitical front, the fourth quarter saw China and the United States open communications channels, when Presidents Xi Jinping and Joe Biden met in California in November. They discussed reopening military communications, climate change, artificial intelligence (AI) and the upcoming Taiwanese election. This marked a positive step at a time when tensions between the two superpowers had been simmering for months. China's economy continues to stutter despite its incremental policy loosening to bolster growth prospects.

Looking forward, the trade-off between growth and inflation will come into sharper focus. This reaffirms our preference for investing in high quality businesses which compound earnings over the cycle.

[1] Bloomberg

[2] Bloomberg

[3] Bureau of Economic Analysis

[4] Bloomberg

[5] Bloomberg

[6] Eurostat

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