

## US Rates Watch

## Connecting the dots in rates

**10y rate a function of cuts while Fed on hold**

While the FOMC may deliver another hike later this year – our base case scenario – the Fed is largely done. The new driver of 10y rates in our view is the market pricing of cuts. Most of the cuts the market price come in 2024, but the cutting path extends through 2026. At the moment, about 88bp of cuts are priced into 2024, using the difference in Dec 2023 and Dec 2024 FOMC OIS (overnight index) swaps. In mid-July, when 10y rates were around 3.75%, the market was pricing about 150bp cuts for 2024. As we discussed in [Finding a higher “neutral” ground 10 August 2023](#), the 10y rate is largely determined by the 1y rate 3 years forward, which is a function of the quantity of cuts the market prices for the next 2 years beyond the Fed’s peak level, which is expected in Dec 2023.

**FOMC meeting could push against market cuts**

With tomorrow’s FOMC meeting delivering a new set of dot forecasts, we take a look at how the 10y rate could mechanically change under simplified assumptions for the number of Fed cuts priced in 2024. Given the ongoing resilience of GDP growth and slowly falling core PCE, our Economics team expects the Fed to guide for less cuts versus their June forecasts (see [Federal Reserve Watch: Sep FOMC preview: all about the SEP 14 September 2023](#)). Not only do the median dots matter, but so do the averages and the overall distributions.

**Scenario analysis on 2024 dots**

In our view, the most important year for the rates market impact will be the 2024 dots and these currently reflect a median expectation of 100bp of cuts based on Fed forecasts for weak GDP growth (1.1%), rising unemployment (4.5%), and low inflation (2.5% headline PCE). Dots for years beyond 2024 carry much lower conviction levels and we think will matter a bit less. The long-run dot, however, is important for markets as it reflects the Fed’s view on the “neutral rate” which has been getting a lot of attention in recent weeks due to the resilience to higher rates observed so far. Our Econ team is calling for 2024 dots to reflect a median of 3 cuts instead of 4 but see a chance that the new dots reflect only 2 cuts.

Exhibit 1 shows the hypothetical change in rates and curve slopes assuming the market prices 3, 2, 1, or 0 hikes into 2024 and leaves the rest of the cutting path unchanged. We see a +10bp move in 10y rates if the market moves to 3 cuts next year, from about 3.4 cuts currently priced. With 2 cuts priced into 2024, the 10y rate could rise 33bp. In all of the scenarios where cuts are removed from 2024, the curve steepens, with the 2-10 slope performing the best out of 2-5, 2-10, 5-10 and 10-30. These market moves likely overstate the actual market impact as the Fed dots are not viewed as commitments but rather base-case expectations contingent on the incoming macro data.

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**Exhibit 1: Implied changes in term rates and curve slopes if 2024 cuts reduce to 3, 2, 1, or 0.**

Assumes markets price exactly 3, 2, 1, or 0 cuts in 2024 while leaving the 2025 and 2026 path unchanged

Change from spot	3 cuts	2 cuts	1 cut	0 cuts
2y rate	8	23	36	46
5y	9	30	51	70
10y	10	33	56	77
30y	10	34	59	83
2-5 slope	1	7	15	24
2-10	2	10	20	32
5-30	1	4	8	13

Source: BofA Global Research

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