Liquid Insight

# Ghosts of cutting cycles past

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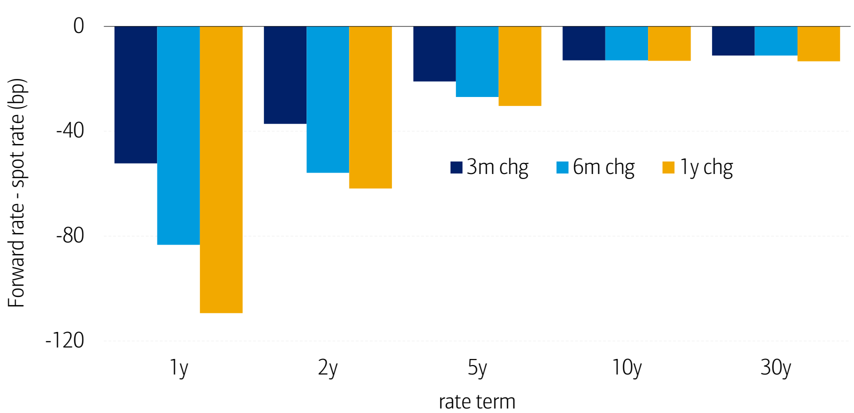
Rates and Currencies Research
Global

## Key takeaways

- Historical cutting cycles show lower rates / steeper curve result from transitioning from pricing hikes to pricing cuts.
- Today's cycle is unique in how early cuts were priced. Bond bulls will need more than the 200bp of cuts currently priced.
- Conditions that give Fed confidence to cut could imply lower 10y rates because of a lower terminal rate vs current market.

***By R. Axel, M. Cabana, B. Braizinha, M. Swiber***

**Chart of the day: Rate markets price all the action in the front end for 2024**
Forward market changes represent a profitability threshold for financed trades done today




**Source:** BofA Global Research

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## History is whispering to us

We view the 5 Fed cutting cycles after 1986 as the most relevant comparisons for today because pre-1986 saw extreme volatility in policy along with periods of money-supply targeting. Starting with Greenspan in 1987, the Fed adopted the framework built by Paul Volcker which continues today. These 5 modern cycles provide 2 main lessons for today's traders: 1) conditions that lead to Fed cuts also lead to lower long-term rates, as markets transition from pricing hikes to pricing cuts, and 2) steepeners have tended to work substantially better during acute financial stress (2001 and 2007) vs. periods of normalization – the faster the Fed cuts, the better for the steepener. Our house call is for a slow cutting cycle which would not support a rapidly steepening curve. We look at historical cutting cycles below to highlight these main takeaways.

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### Market transitions from pricing hikes to pricing cuts in each cycle

The past 5 cycles in which the Fed transitioned from hikes to cuts include 3 periods of recession (1990, 2001, 2008) in which the unemployment rate rose, and 2 soft landings with a stable or declining unemployment rate (1995, 2019). Large financial shocks (2000 NASDAQ crash and 2007 housing market crash) were behind 2 of the recessions, and an oil price shock was the main culprit behind the 1990 recession. The 2 soft landings of 1995 and 2019 had no exogenous shocks and no recession. They led to minor cutting cycles of 3 cuts each and little curve steepening. Common across all the cutting cycles is that rates declined and the 2-10y curve steepened between the last hike and the 1st cut (Exhibit 1). The driver of these moves in all cases was a market transition from pricing hikes to pricing cuts. Major curve steepening episodes aligned with recessions in which job losses accumulated and the Fed eased well below neutral. We showed in US Rates Watch: The big picture for long-term interest rates, that 10y rate levels are largely determined by the Fed policy level and near-term Fed policy expectations even away from Fed transitions. Changes in policy expectations we think will again be key for the current period as we wait for the Fed to potentially begin cuts with a market currently pricing 200bp cuts over 2 years. This cycle is unique in that markets priced cuts well before any of the last 5 cycles, so in this sense the bar is higher for a material rally before the 1st cut.

### Overview of the past 5 cycles

Exhibit 1 shows that rates rallied most in the lead up to the 1995 cutting cycle – which only delivered 3 cuts. This is because the market was very surprised by the Fed's pivot in early 1995 and wound up making a large adjustment quickly in Fed path pricing which brought 10y rates down rapidly. A similar story held for the large rally leading into the 2001 cuts. At the end of the 2000 hiking cycle, the market was still pricing hikes and as the Fed remained on hold and the NASDAQ fell, the market transitioned to pricing cuts before the Fed delivered. In 1989, the market was slowly and steadily transitioning out of hike expectations and continued pricing more cuts while the Fed was on hold, pulling 10y rates down. The 2006 cycle was again similar, but the market did not price material cuts until the macro outlook worsened dramatically in summer 2007 while the Fed remained on hold. The rapid transition to pricing cuts not only drove a sharp rally in 2007 but a large curve steepening. Yet again, a similar story played out in 2018 as the market continued to price hikes until the stock market correction in Dec 2018 which allowed the market to pricing increasingly more cuts though mid 2019 which brought 10y rates from 3.25% to 1.5% by mid-2019. The cuts of 2020 did not follow a hiking cycle but were a Fed crisis response of – 150bp across 2 weeks which led to a dramatic duration rally and a pop steeper in 2-10y curve.

**Exhibit 1: Overview of the past 5 transitions to Fed cutting cycles: asset prices up**
Change in 10y since Fed's last hike in Jul '23 = +14bp, 2-10y curve change = +62bp

| Last hike | First cut | total hikes (bp) | mo's to 1st cut | size 1st cut (bp) | 10y chg last hike to 1st cut | 2-10y chg last hike to 1st cut | SPX chg last hike to 1st cut |
|---|---|---|---|---|---|---|---|
| 24 Feb 89 | 5 Jun 89 | 325 | 3.3 | -12.5 | -101 | 22 | 12% |
| 1 Feb 95 | 6 Jul 95 | 300 | 5.1 | -25 | -163 | 20 | 18% |
| 16 May 00 | 3 Jan 01 | 175 | 7.7 | -50 | -127 | 68 | -8% |
| 29 Jun 06 | 18 Sep 07 | 425 | 14.8 | -50 | -72 | 49 | 19% |
| 19 Dec 18 | 31 Jul 19 | 225 | 7.4 | -25 | -74 | 3 | 19% |
| | avg | 290 | 8 | -33 | -107 | 32 | 12% |

**Source:** BofA Global Research

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### Curve steepener has been more variable across cycles

The behavior of the curve was more variable than 10y rate levels leading up to the 1st cut in the past 5 cycles. The steepener performed best when the Fed started fast with 50bp cuts in the 2 major financial shock cycles, providing 50-70bp of steepening leading into those aggressive starts. The curve steepened only about 20bp going into the 1989 and 1995 cuts, and 3bp in the lead up to 2019 cuts. Our base case for the 2024 cuts is that they will look more like the slower starts with less curve steepening. But so much steepening is priced in – as shown in the Chart of Day. Markets already price 2y rates to decline 50bp in 6 months with 10y rates only priced to decline by 10bp. This gives a bar of about 40bp of steepening already baked into 2-10y into the beginning of the cutting cycle – presumably about 6 months away.

Some of the variability of the curve dynamic over recent cycles may also be attributed to changes in neutral rate expectations for US economy (see Exhibit 2 and our note on The curve dynamic & the neutral rate). A lower neutral implies both a lower bear steepening potential in the early expansion phase of the cycle, and a lower bull steepening potential over periods of policy easing.

**Exhibit 2: 2-10y bull steepening dynamic vs neutral rate view**

Curve levels (y-axis) vs fed funds (x-axis) … curve forwards consistent with neutral rate expectations c.3-3.25%%

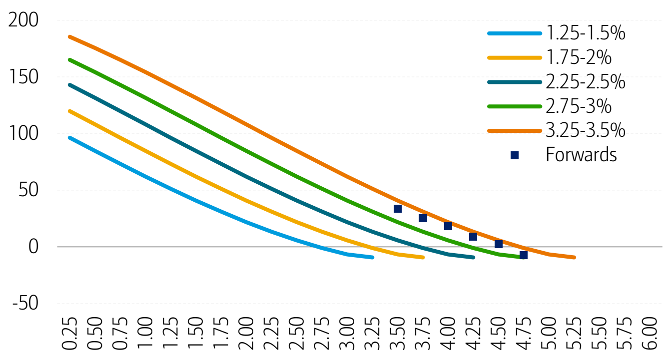


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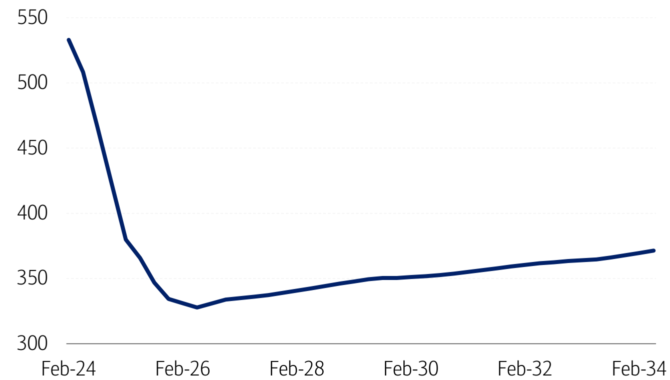
**Exhibit 3: Policy trajectory currently priced in for the Fed**

Fed priced to reach the policy trough c.3-3.25% by late '25 / early '26

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### Today's cycle is unique in transitioning so early to cut expectations

In our view, the key story from history is that the transition from hike expectations to cut expectations has been the driver of rate rallies and curve steepening. Today's cycle is unique because the market began transitioning to cut expectations well before the Fed went on hold. The 1y expectation priced cuts already by late 2022, while the Fed's last hike was in July 2023.

This could imply that the rate rally is done, as the big transition has already occurred. But the key going forward will be the terminal level the market prices the Fed to cut down to – which is still relatively high compared to the post-2008 experience, especially vs where the Fed was before the pandemic (1.5%-1.75% range). The market today is hesitant to price the Fed to return to that low policy rate because of very strong growth, which adds uncertainty to the inflation outlook. This is part of our base case forecast of 4.25% 10y rates for end 2024.

If the Fed continues to receive benign inflation data – as we expect – it should provide the confidence that Powell is looking for to initiate cuts. In this case, the market could also price a lower landing spot for the Fed (currently c.3-3.25% – see Exhibit 3), i.e., more cuts. The Fed pencils in a long-term neutral policy level of 2.5% in their dot plots. If inflation continues to normalize and growth slows, markets could adjust terminal down to 2.5% (see Road to 3%) which could mechanically push 10y rates about 80bp lower. But the curve could remain relatively flat if the market anticipates that Fed will prefer to hold at the terminal rate.

As we noted in Exhibit 2, the market may be pricing a neutral in the 3-3.25% context currently (the dynamic of 2-10y curve forwards vs 3m OIS forwards is consistent with a bull flattening trajectory implied by neutral rate expectations c.3-3.25%). A repricing of the neutral lower (see Rates dynamic vs neutral rate expectations) has the potential to cap the bull steepening dynamic for the 2-10y curve as the Fed cuts rates (i.e., resets the 2-10y trajectory to a lower neutral rate assumption in Exhibit 2).

**Duration seems more asymmetric than curve in the tail scenarios**

If markets are surprised, it could be either a Fed that stays on hold much longer with sticky inflation, or a Fed that cuts fast and deep due to either a dramatic economic downturn or a crisis event. The steepener position likely has a symmetric payoff in these tails, where a Fed on hold would maintain the inversion for a long period of time while emergency cuts could provide a dramatic steepening. But the duration trade appears more asymmetric as it could perform well potentially in both scenarios. The emergency cut scenario is clear. But if the Fed stays on hold, the market can continue to price the same cutting cycle for the future, and the 10y could remain unchanged are moderately higher. The worst-case scenario for the long duration trade is the return of Fed hikes, but the Fed has strongly communicated that they believe the policy rate is now “well into” restrictive territory, which should make the bar high for additional hikes even in a sticky inflation scenario. A Fed more likely to cut than hike leaves us more comfortable buying dips in bond prices rather than adding to steepening positions when the curve flattens on strong data like Friday’s payrolls.

# Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Into month-end and the Fed, **Liquid Cross Border Flows**, 29 Jan 2024

# Rates, FX & EM trades for 2024

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Despacito 02 February 2024

Global Rates Weekly: Confidence test 02 February 2024

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