Liquid Insight

Thinking the unthinkable: what if no central bank cuts rates this year?

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Rates and Currencies Research
Global

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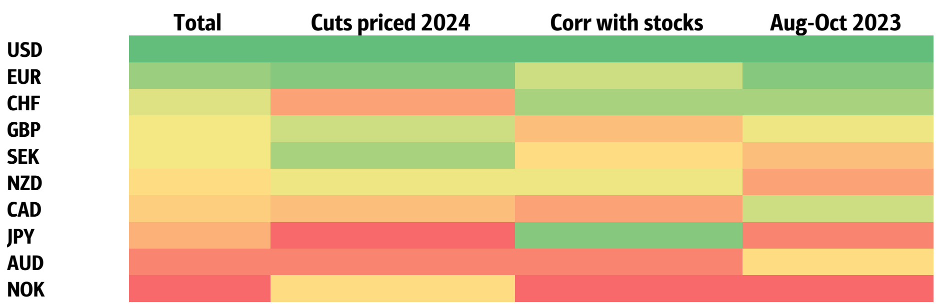
Key takeaways

- No rate cuts this year unrealistic, but implications relevant in market pricing aggressive cuts without much differentiation.
- Likely positive for USD, EUR, CHF vs. NOK, AUD, JPY. Impact depends on difference from current market pricing.
- We remain bearish on USD this year on expectations of rate cuts in soft landing, but see choppy path given market pricing.

By Athanasios Vamvakidis

Exhibit 1: G10 FX performance ranking in scenario of no central bank rate cuts in 2024
USD, EUR, CHF likely to perform the best against NOK, AUD, JPY if no G10 central bank cuts rates this year



Source: BofA Global Research. Note: Equally weighted ranking of three forces driving G10 FX in scenario of no central bank rate cuts this year. The total reflects the sum of the three rankings. Green for positive FX impact, red for negative FX impact, yellow for neutral FX impact. See Exhibits 1-3 for detailed data. Colors use Excel conditional format.

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For the sake of the argument

The most important discussion in the market as the new year has started is not if, but when and how fast G10 central banks will start to cut policy rates. Even if a scenario of central banks staying on hold this year may seem completely unrealistic to the consensus, it is still worth considering its market implications in our view, as we are puzzled by the aggressive market pricing of rate cuts this year.

As a contrarian exercise, we rank G10 currencies in a scenario of no rate cuts according to: market pricing, correlation with equities, and market reaction during Aug-Oct last year when the market priced out rate cuts. The results in Exhibit 1 suggest that USD, EUR and CHF would likely perform the best against NOK, AUD and JPY. We may see a similar market reaction if rate cuts come later or slower than market pricing, with the size and duration of the impact depending on the difference. The results are also relevant if the market starts to differentiate more according to the latest inflation dynamics. We remain bearish on the US this year, but see a choppy path.

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Not so fast

The most important discussion in the market as the new year has started is not if, but when and how fast G10 central banks will start to cut policy rates. Market pricing suggests six cuts for the Fed and the ECB, starting in March and in April respectively, five cuts by the BoE and two cuts by the RBA. We have less cuts for all of them: four for the Fed, three for the ECB, two for the BoE and none for the RBA. The reasons for these differences include our expectations for sticky inflation on the way down, in resilient economies, with stretched labor markets. In our year ahead discussions with investors, nobody has considered a scenario in which no central bank cuts rates this year.

However, even if a scenario of central banks staying on hold may seem completely unrealistic, we think it is still worth considering its market implications, at least as a contrarian exercise. After all, markets were expecting early rate cuts last year, which did not take place. We consider the market's aggressive pricing of rate cuts in a very soft-landing scenario, with still extremely low unemployment, without differentiating enough among different G10 central banks, almost equally unrealistic. The truth may be somewhere in the middle, which is indeed where our forecasts stand.

We are puzzled by the aggressive market pricing of rate cuts this year. Three possible explanations are not very likely in our view:

- If central banks have overtightened, they should cut rates fast as inflation comes down, but we don't see any evidence to support such argument so far. Growth has surprised to the upside in this tightening cycle and nothing of systemic nature has broken. The drop in headline inflation last year had primarily to do with the drop in energy prices and temporary supply-related bottlenecks from the pandemic. Core inflation has been stickier. Inflation expectations have started to fall recently, but after having increased in the last two years. In our view, if central banks had not tightened decisively while dealing with the highest inflation, lowest unemployment and looser fiscal and monetary policies in decades, following a faster than expected recovery from the pandemic and extreme valuations in risk assets, after their initial view that inflation was transitory proved to be wrong and after having gone to extremes with unconventional policies in the low-inflation era, inflation expectations would have increased even more. As Larry Summers recently argued, "if the transitory inflation people turn out to be right, it will be only because their advice was not followed". If it does turn out that some central banks have overtightened, they can easily cut rates faster if inflation drops fast this year and/or growth is weak, but we find hard to believe that this is the case for most central banks, which is what the market pricing seems to suggest, and definitely not the case for the Fed.

- Hard landing can justify early and fast rate cuts, but the performance of risk assets is not consistent with such concerns. We do believe that unique conditions led to last year's "miracle" of falling inflation without a landing, suggesting the growth-inflation mix this year could be worse. We believe that the drop in inflation had more to do with 1-off forces than with monetary policy tightening. The previous long era of low inflation suggests corporates and households are locked in low interest rates, in turn pointing to much longer than usual lags in the impact of monetary policy on the real economy. At the same time, loose fiscal policy and excess savings from the massive, pandemic-related fiscal stimulus supported the economy, particularly in the US. All this suggests that the monetary policy tightening that has already taking place has affected primarily inflation expectations, but may start to affect the real economy more this year. Maybe the market is pricing a risk premium for hard landing as a result, but this would suggest that rates are more concerned about such a scenario than most other asset classes.

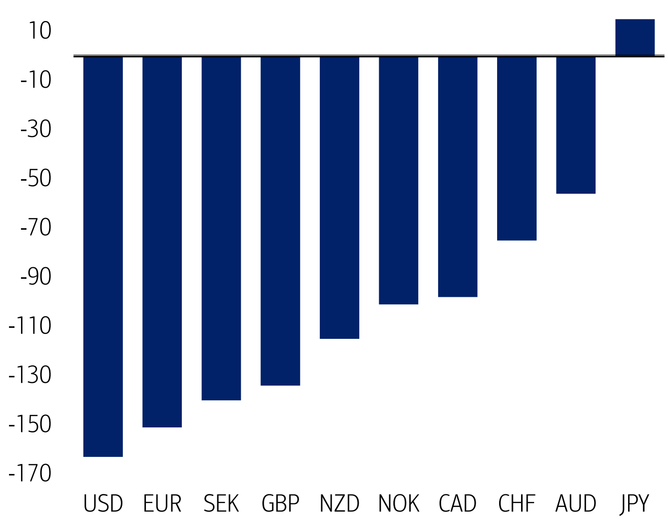
- If inflation continues to fall, central banks would have to cut rates to avoid a further increase in real policy rates that could lead to overtightening. This may be the most possible explanation in our view and consistent with what Powell has recently argued. However, even in this case, we would expect central banks to err on the side of caution and wait for more data to confirm that inflation continues to fall this year, particularly as headline inflation is now increasing again because of the strong base effects from the drop in energy prices last year. This is consistent with our call for mostly later and slower rate cuts.

A contrarian exercise

We try to assess the FX market reaction to an extreme scenario in which no G10 central bank cuts rates this year. Of course, a lot also depends on whether central banks remain on hold because growth is strong, inflation is sticky, or new shocks push inflation higher.

As an illustration, we look at three different angles, equally weighted for our bottom line. One could use different weights, depending on whether central banks stay on hold because of growth or inflation considerations. We rank G10 currencies based on: current market pricing of central bank policy rate cuts (Exhibit 2); correlation with equities during the last two years of monetary policy tightening (Exhibit 3); and how currencies traded during August-October last year, as the market priced out rate cuts for 2023 (Exhibit 4).

Exhibit 2: Rates market pricing for G10 central banks in 2024
Market pricing aggressive rate cuts for most G10 central banks in 2024



Source: Bloomberg, BofA Global Research.

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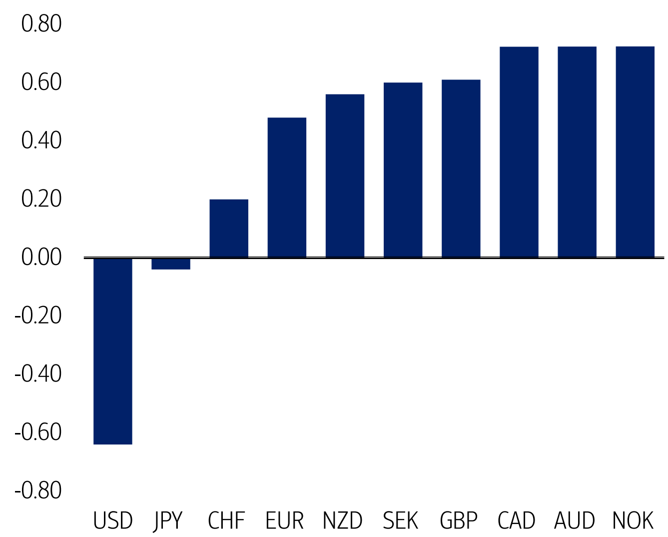
Exhibit 3: G10 FX-equities correlation last 2 years (tightening cycle)
USD only in G10 negatively correlated with equities during tightening cycle



Source: Bloomberg, BofA Global Research.

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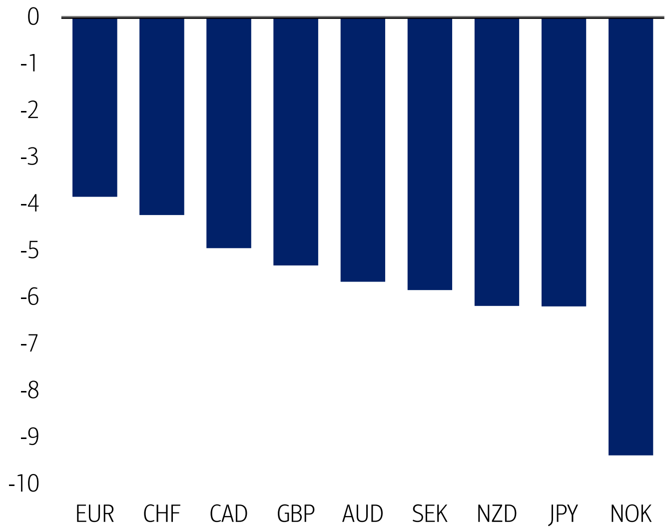
Exhibit 4: G10-USD crosses during August-October 2023 (when market priced out rate cuts for 2023)

High beta G10 and JPY performed the worst, USD the best when market priced out cuts last year



Source: Bloomberg, BofA Global Research.

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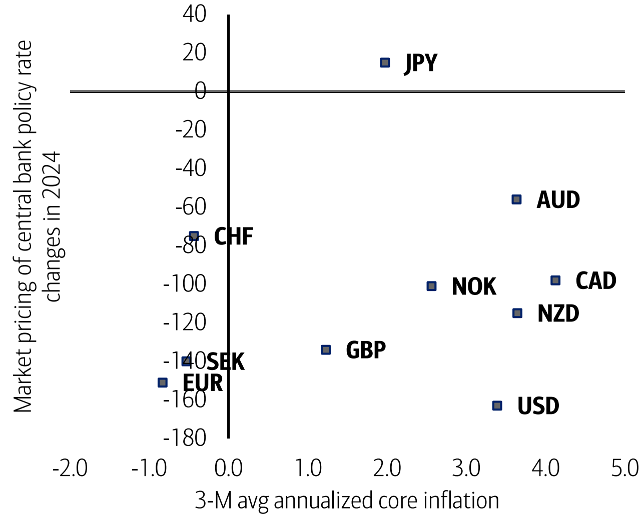
Exhibit 5: G10 inflation dynamics and rates market pricing

Market not differentiating enough in G10 rate cuts based on inflation



Source: Haver, Bloomberg, BofA Global Research. Note: inflation data up to Nov 2023.

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The results in Exhibit 1 suggest that USD, EUR and CHF would perform the best against NOK, AUD and JPY if no G10 central bank cuts rates this year. GBP, SEK, NZD and CAD would likely be somewhere in the middle, in this sequence. The USD would do the best, consistent with what took place during this tightening cycle. Risk-off would weigh on high beta G10 currencies. JPY would also weaken, as monetary policies convergence vs. current market pricing. The EUR would also find support, given the aggressive rate cuts that the market is currently pricing, although the USD will do even better.

Back to reality

We may see a similar market reaction, at least temporarily, if rate cuts come later and/or are slower than market pricing. Indeed, as we discussed above, our baseline is less aggressive on rate cuts than market pricing this year.

A lot also depends on whether rate cuts are delayed, or whether central banks end up cutting by less than market pricing during the loosening phase of the cycle—higher terminal rates. In our baseline, rate cuts in a soft landing would be negative for the USD and positive for high beta G10 currencies. However, later and slower cuts do suggest risks for some market turmoil as the rates market adjusts, supporting the USD at some point in the first half of the year. As long as rate cuts proceed, this should be temporary and we would sell the USD rally. In the meantime, we remain bullish EURUSD, expecting the Fed to start cutting rates in March—consistent with market pricing—while the ECB in June—vs. market pricing for April. However, if rate cuts are pushed for much later, or central banks are not able to cut by as much as markets expect once they start, the FX market will react by more and the impact will last longer.

As we argued above, it is also unlikely that the market is right about aggressive rate cuts across the board. Exhibit 5 suggests that the market is not differentiating enough in G10 based on the latest inflation dynamics. The correlation between the two should be positive—lower inflation, more cuts—but it is almost zero. It is likely that at least some central banks may end up cutting by less. More differentiation can support the USD against JPY and CHF, at least temporarily. Indeed, we are less bearish than the consensus in USDJPY, with a forecast of 142 by end-2024 vs. a consensus of 135, and we prefer to be short CHF vs. EUR, rather than against the USD this year.

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- **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
- USD breather, **Liquid Cross Border Flows**, 8 Jan 2024

Rates, FX & EM trades for 2023

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: The long and choppy rest of the year ahead 12 January 2024

Global Rates Weekly: Quantitative Teasing 12 January 2024

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