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Interest rate volatility: Transitory or here to stay?

Global Matters Weekly

13 November 2023

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Following the start of the US Federal Reserve's belated rate hiking cycle in March 2020, this year has seen a marked pickup in interest rate volatility and a significant increase in the benchmark 10-year yield in recent months, which have contributed to broader economic uncertainty. So, what exactly has been driving this volatility and is this trend going to reverse anytime soon?

Many factors are responsible, some of which are more transitory in nature, but many reflect uncertainty about more structural issues. One factor has been the resilience of the US economy during the third quarter, which has led investors to believe the Fed will maintain rates higher for longer, thereby shifting short-term rates expectations and long-term rates higher.

Another has been the surge in long-dated bond issuance by the US Treasury last quarter which generated a spike in supply, further exacerbated by the fact that the two largest buyers of US Treasuries have simply stopped buying. China and the Fed, in recent decades amassed trillions of dollars in Treasuries, issued to finance the deficits that emerged following the 2008 Global Financial Crisis and the COVID-19 pandemic. China started buying US Treasuries twenty years ago as the economy was booming, to keep a lid on its strengthening currency and ensure competitive exports. Today as the currency weakens, China is no longer buying Treasuries and may even look to sell some of its large supply. In the US, with the Fed's quantitative tightening program (reduction of its balance sheet), the bond market has essentially lost a significant technical support. Indeed, the Fed was a price-insensitive bond buyer. The flipside of losing these price-insensitive bond buyers is that they have been replaced by price-sensitive buyers, such as hedge funds, which has contributed to heightened market volatility.

With long-term rates soaring to the levels they have (10y treasury yields breached 5% last month), Central Bank rhetoric has turned more dovish, with various Fed speakers stating that the resulting tightening in financial conditions could be doing some of the work normally attributed to monetary policy tightening. That helped Treasuries to rally, before their progress was abruptly halted by an underwhelming 30-year bond auction last week, prompting a 15bps rise in long-term borrowing costs on the day. Taken together, these outsized moves in bond yields show just how difficult it is to position oneself in this market currently.

> It is of prime importance to carefully watch and assess all of the factors affecting growth, inflation, and fiscal sustainability in coming years

Looking forward, there remains significant uncertainty concerning key inputs influencing long-term rates. For one, nominal GDP growth, which accounts for real GDP growth plus inflation, has experienced substantial volatility lately. There are mixed views on whether real potential GDP will remain muted or whether the burgeoning AI-driven revolution will boost productivity growth, and in turn GDP growth, over the coming years.

Another highly uncertain element is whether inflation will return below target and if so, will it remain there in a sustained fashion. How will climate change and deglobalisation influence this trend? Will inflation need to be engineered higher in order to combat the crippling refinancing costs following the surge in public debt and the sustained large-scale deficit spending implemented during the historically low interest rate era.

Something must give between the uncertain growth/ inflation picture; the debt shock that will need to be addressed by Central Banks; and the increasing term premia demanded by investors to compensate for future interest rate and geopolitical shocks. It is of prime importance therefore to carefully watch and assess all of the factors affecting growth, inflation, and fiscal sustainability in coming years. Given the difficulties in identifying structural shifts in each, one would need a crystal ball to ascertain the macroeconomic landscape of the next couple of years. However, one can say with a degree of certainty that we're not out of the rates volatility woods yet

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The Marketplace

- Global equities rose 0.6% last week
- Brent crude fell 4.1% last week to $81.43 per barrel, closing for the first time below its level prior to the Hamas attack on Israel
- Gold fell 2.6% to $1940.2 per ounce

Market Focus

US

- US equities rose 1.3% last week
- In remarks at an International Monetary Fund conference, Federal Reserve Chair Jerome Powell said that "if it becomes appropriate to tighten policy further, we will not hesitate to do so"
- The Senior Loan Officer Opinion Survey from the Federal Reserve continued to show improvement in banks' willingness to lend, however still reported tightening standards for mortgages
- Moody's shifted its AAA credit rating of the US from "stable" to "negative", citing large fiscal deficits and a decline in debt affordability
- The preliminary results of the University of Michigan's consumer sentiment survey, came in below expectations at 60.4 (vs 63.7 expected)

Europe

- European equities rose 0.1% last week
- Industrial production in Germany contracted by 1.4% in September (vs -0.1% expected), whilst the construction Purchasing Managers Index for October fell back to 38.3
- Wage growth in France came in at 0.5% quarter-on-quarter (1.0% previously), marking the slowest quarterly wage growth in two years

UK

- UK equities fell 0.5% last week
- Bank of England's Chief Economist Huw Pill stated that financial markets pricing in rate cuts later in 2024, "doesn't seem totally unreasonable"

Asia/Rest of The World

- Global emerging market equities were flat last week
- Japanese equities rose 0.6% last week
- Chinese equities fell 1.3% last week
- Trade data from China showed exports declining for a sixth consecutive month, dropping -6.4% year-on-year, while imports surprisingly rebounded 3%
- The Reserve Bank of Australia lifted its cash rate for the first time in five months by 0.25% to a 12-year high of 4.35%, citing a slower-than-expected decline in inflation

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Asset Class/Region	Currency	Currency returns			
		Week ending 10 Nov. 2023	Month to date	YTD 2023	12 months
Developed Market Equities					
United States	USD	1.3%	5.3%	16.1%	12.9%
United Kingdom	GBP	-0.5%	0.7%	2.2%	3.6%
Continental Europe	EUR	0.1%	2.7%	8.3%	6.4%
Japan	JPY	0.6%	3.7%	26.4%	23.8%
Asia Pacific (ex Japan)	USD	-0.4%	3.2%	-1.5%	8.7%
Australia	AUD	0.1%	3.0%	2.8%	4.4%
Global	USD	0.6%	4.8%	13.1%	11.8%
Emerging markets equities					
Emerging Europe	USD	-1.3%	1.8%	18.9%	31.6%
Emerging Asia	USD	0.2%	3.3%	0.2%	11.2%
Emerging Latin America	USD	0.0%	7.6%	15.7%	14.1%
BRICs	USD	-0.2%	2.4%	-2.6%	10.0%
China	USD	-1.3%	1.2%	-10.2%	10.9%
MENA countries	USD	0.7%	2.7%	-1.2%	-7.3%
South Africa	USD	-4.8%	3.2%	-8.7%	-6.8%
India	USD	0.8%	1.8%	7.6%	5.6%
Global emerging markets	USD	0.0%	3.7%	1.4%	9.5%
Bonds					
US Treasuries	USD	-0.3%	1.6%	-0.9%	-0.3%
US Treasuries (inflation protected)	USD	-0.6%	1.4%	-0.3%	-0.2%
US Corporate (investment grade)	USD	0.0%	2.3%	0.9%	3.4%
US High Yield	USD	-0.3%	2.1%	6.9%	7.7%
UK Gilts	GBP	0.1%	1.8%	-2.9%	-6.9%
UK Corporate (investment grade)	GBP	0.2%	1.8%	2.8%	2.6%
Euro Government Bonds	EUR	-0.2%	1.0%	1.4%	-2.5%
Euro Corporate (investment grade)	EUR	-0.2%	0.6%	3.4%	3.2%
Euro High Yield	EUR	0.2%	1.0%	6.9%	8.4%
Japanese Government	JPY	0.8%	1.0%	-1.1%	-2.6%
Australian Government	AUD	0.5%	1.6%	0.1%	-1.2%
Global Government Bonds	USD	-0.6%	1.6%	-3.1%	-1.6%
Global Bonds	USD	-0.5%	1.9%	-1.0%	0.8%
Global Convertible Bonds	USD	-0.6%	1.8%	0.2%	1.7%
Emerging Market Bonds	USD	-0.8%	2.3%	0.5%	5.0%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 10 Nov. 2023	Month to date	YTD 2023	12 months
Property					
US Property Securities	USD	-2.4%	3.3%	-4.1%	-8.2%
Australian Property Securities	AUD	1.0%	7.6%	-0.8%	-0.9%
Asia Property Securities	USD	-2.1%	1.8%	-12.5%	-2.9%
Global Property Securities	USD	-2.1%	3.8%	-4.7%	-4.7%
Currencies					
Euro	USD	-0.5%	1.0%	-0.3%	5.3%
UK Pound Sterling	USD	-1.3%	0.6%	1.0%	4.9%
Japanese Yen	USD	-1.4%	0.0%	-13.6%	-6.2%
Australian Dollar	USD	-2.4%	0.3%	-6.8%	-3.1%
South African Rand	USD	-2.8%	-0.3%	-9.1%	-6.8%
Swiss Franc	USD	-0.5%	0.8%	2.2%	7.4%
Chinese Yuan	USD	0.2%	0.4%	-5.4%	-1.4%
Commodities & Alternatives					
Commodities	USD	-3.0%	-2.6%	-3.1%	-4.6%
Agricultural Commodities	USD	-0.7%	0.1%	0.9%	1.7%
Oil	USD	-4.1%	-6.8%	-5.2%	-13.1%
Gold	USD	-2.6%	-2.2%	6.4%	11.0%

Source: Bloomberg. Past performance is not indicative of future returns

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