Ostrum ASSET MANAGEMENT

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Market views and strategy

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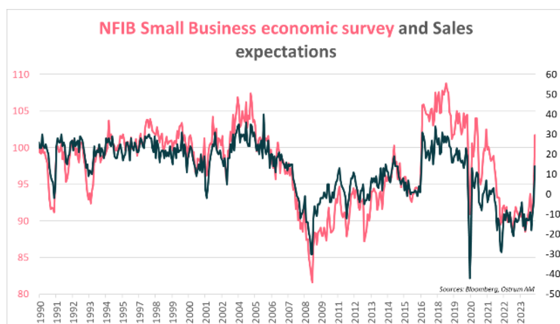
Topic of the week: A round-up of central bank policies
by Axel Botte

- The Fed is gradually removing monetary restriction. Fed funds rates may decline to 4% by March. Donald Trump's agenda may weigh on growth and raise inflation through tariffs. Should unemployment rise further, the employment part of the dual mandate will gain weight in the Fed's decision making. The terminal rate of the easing cycle is forecasted at 3.5%;
- The ECB may have room to cut deposit rates to 2.25%. However, wage inflation is still posing upside risks to inflation. For this reason, the ECB may not be able to cut real rates in negative territory. The BoE is facing similar price stickiness whilst the Riksbank will keep cutting rates mirroring the ECB's rate path;
- The BoC and the RBNZ will remain the proactive central banks against the backdrop of rising unemployment;
- The SNB is fighting upward pressure on the Swiss Franc with a 50-bp cut in December. Swiss interest rates may revert to negative territory in the coming years if need be;
- The Norges Bank is maintaining a hawkish status quo but is unlikely to tolerate NOK appreciation;
- In Asia, the growth challenges in China suggests that the PBoC will keep cutting interest rates. Conversely, the Bank of Japan will proceed cautiously with rate hikes.

Market review: Rate cuts fail to tame long-term yields
by Axel Botte

- The ECB lowers its growth and inflation forecasts and cuts its rate by 25 basis points;
- China's budget support plan disappoints the markets;
- A very negative week for bond markets. The T-note around 4.35%;
- Credit weathers the rate shock despite wider iTraxx Crossover spreads.

Chart of the week



The NFIB survey from November seems to reflect a wave of optimism among US small businesses following Donald Trump's election. Revenue forecasts are showing a significant increase. Promises of tax cuts and deregulation resonate with SMEs.

The rise in tariffs is perceived as initially protective, even though all signs suggest that protectionism will be detrimental to both the American and global economies.

Figure of the week

4

4 as the number of Prime ministers in France and the number of interest rate reductions by the European Central Bank in 2024.
Source: Ostrum AM, Bloomberg

Topic of the week

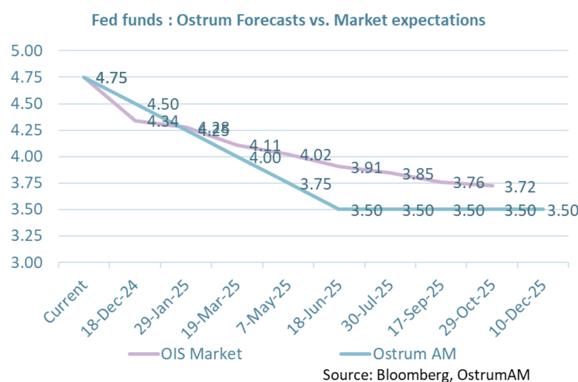
A round-up of central bank policies

Global central banks have eased monetary policy in the past six months or so as inflation decelerates. Their messages have however been more mixed recently. The incoming administration in the US is threatening to impose tariffs and restrict immigration. Such negative supply shocks have the potential to add to inflation. Some central banks have alluded to a softer monetary stance to cushion their economies against aggressive US trade policies. In this piece, we lay out our outlook for the main central banks in 2025.

Federal reserve: rates to drop to 4% by March, then Powell will reassess the situation.

Fed: no-brainer cuts to 4%, and then some as the Fed assesses Trump policies

The Federal Reserve has started its easing cycle with mixed success as regards the long end of the yield curve. The 10-yr note initially shot up before drifting down towards 4.20%. The trade and immigration policies put forward by Donald Trump may raise inflation and slow growth creating a dilemma for the Fed. The dual mandate is to raise maximum employment in the context of price stability. Our forecasts suggest that growth will slow below potential to 1.6% next year with inflation likely to remain above target. The Fed has some leeway to reduce interest rates to 4% (by 25-bp increments at each meeting until March). The perceived leeway comes from the Fed's belief that current policy is restrictive, which is debatable considering the strength in domestic spending throughout 2024. A corollary is the level of the (always elusive) neutral interest rate. These questions will come into play fairly soon.



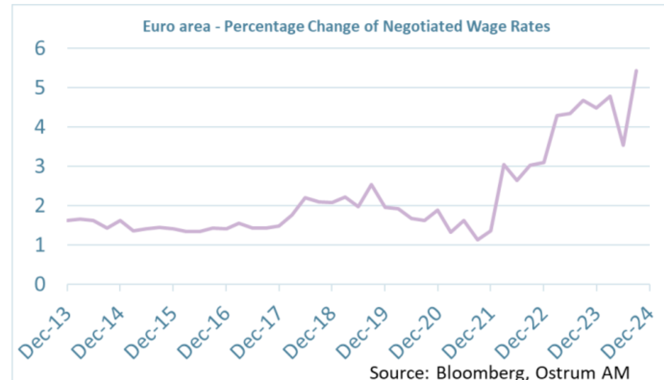
In our opinion, the Federal Reserve will gradually put more weight on its employment objective and reduce interest rates to 3.5% by the middle of next year. We do not believe that a recession is around the corner in the U.S., but the labor market is cooling. The rise in the unemployment rate is increasingly traceable to permanent job losses as opposed to an influx of new entrants in the labor force. Likewise, the duration of unemployment has increased lately and the underemployment rate including involuntary part-time work has risen to 7.8%, up 0.7pp from cyclical lows. The Fed will likely look at tariff hikes as a temporary price shock as opposed to a long-lasting inflationary impetus. The inflation outcome will ultimately depend on a range of factors including retaliation from foreign countries and domestic wage pressures in the context of slower labor force growth.

Our 3.5% forecast for the terminal rate is near the high end of the neutral rate range (3.75%) from the Fed's September dot plot. We have penciled in more aggressive easing than the current market forecasts due to our lower growth forecast.

ECB: mind the wishful thinking on wage developments.

Is the ECB taking a chance on inflation by ignoring wages?

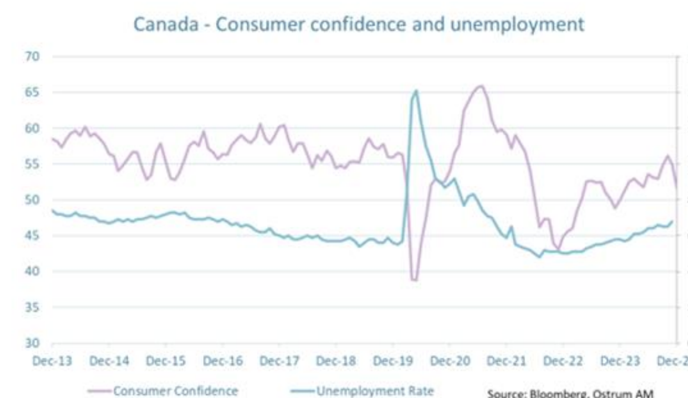
The ECB's monetary policy is a mixed bag of restrictive quantitative measures and interest rate cuts. If anything, the pace of the balance sheet contraction will accelerate in 2025, which will give policymakers even further room for maneuver on policy rates. The euro exchange rate's sensitivity to short-term interest rates means that rate cuts could be effective to insulate the euro area from US tariff hikes. We project a series of measured rate cuts to 2.25% next year. This is somewhat less aggressive than market expectations, which extend the monetary easing effort to 1.50-1.75% in late 2025. It appears that the market is buying the ECB's rosy view on wages. But, despite slow euro area growth in the past two years, the unemployment rate has continued to decline to a new record low of 6.3% in October. Negotiated wages remain upbeat with year-on-year increases of 5.4% in the third quarter, and as much as 8.8% in Germany. The ECB assumes that wages will slow materially in the second half of 2025 and that productivity gains will accelerate to 1% from virtually zero at present. This is a very optimistic scenario to say the least. Service price inflation has been flat at or above 4% for two years and producer prices for consumer goods have picked up recently. In sum, the ECB may underestimate domestic price pressures. That should prevent the ECB from cutting real rates into negative territory. Given our inflation forecast, the floor for the ECB deposit rate should be about 2.25%. Likewise, the Riskbank may follow in the footsteps of the ECB. The Swedish economy has turned the corner and is improving gradually as lower interest rates provide timely relief to borrowers.



BoE : how to deal with stickiness in prices?

The Bank of England is not in hurry to reduce rates. The issue remains sticky price pressures stemming from wage developments and thus high service inflation, even as headline inflation has reverted to target. One member of the MPC even voted to increase rates in November. At the end of the day, the BoE is unlikely to buck the trend for global policy easing but the British monetary institution has a tendency to surprise markets.

BoC, RBNZ among the most proactive central banks



The BoC has been ahead of the G10 pack in this monetary cycle. The sharp rise in the unemployment rate to 6.8% in November combined with benign inflation (1.7% core inflation) resulted in another jumbo cut in December (50 bps).

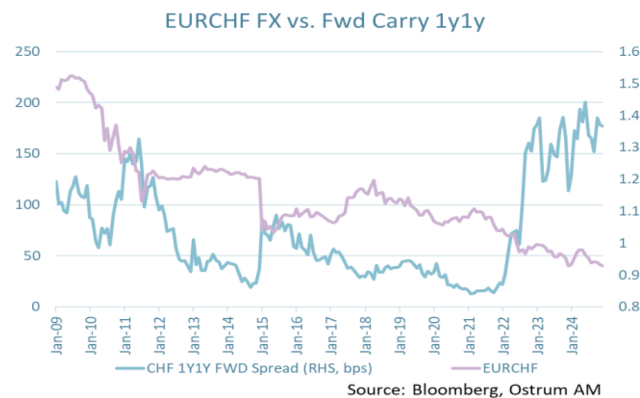
The BoC's dovishness also responds to the threat of US tariffs. The USMCA trade deal will only be reviewed in 2026, but the incoming US administration will exert such pressure on Canada and Mexico early on next year. Canadian dollar depreciation would have to be very significant to prevent the BoC to lower rates further.

The RBNZ shocked the financial world by cutting rates early in August by 25 bps and then doubled down with a 50-bp decrease in September and another 25-bp cut in November. The recession feared by central bankers did not materialize but growth indeed stalled in the third quarter. Surveys are sending mixed messages as regards the economic outlook and we see the RBNZ easing further in keeping with the gradual slowdown in inflation. Wage increases however remain sizeable at 5.3% in the third quarter.

SNB, Norges as asset managers

SNB fighting CHF appreciation.

The Swiss National Bank may cut rates all the way to zero to combat CHF appreciation. Inflation below 1% is no obstacle to continued easing. Forward interest rates are trading in negative territory. We certainly would not rule out negative rates again in Switzerland. The central bank only meets four times a year which arguably raises the odds of large rate moves. The only purpose of monetary policy seems to discourage currency speculation and match excess demand for CHF with outward portfolio investments in a range of financial assets (equities and bonds). And in size. The SNB's portfolio is larger than the underlying Swiss GDP.



The Norges Bank is moderately hawkish but the Bank has an interest in a weaker currency to maximize the value of net external assets (public pension fund assets). For this reason, the Norges Bank is a recurrent NOK seller in the foreign exchange market.

Is the PBoC pushing on a string?

PBoC will intensify its fight against deflation whilst the BoJ is adjusting slowly to sustained inflation.

China's top leadership signaled a shift in its monetary policy stance to "moderately loose" from "prudent". The official statement comes after a reform to the PBoC's monetary framework and several easing measures, including rate cuts and increases in lending facilities. The economic challenges faced by China, such as the deflationary forces stemming from the real estate sector meltdown, are compounded by

expectations of hostile trade policies from the U.S. In any case, policy rates look set to fall further next year and hit near-zero lows in the coming years. The risk is that the PBoC will be pushing on a string in a liquidity trap.

In Japan, the BoJ is, somewhat reluctantly, removing monetary accommodation as inflation takes hold. Rate hikes are on the agenda alongside a reduction in JGB purchases. The BoJ is the only major central bank to consider raising interest rates at this juncture. The pace of tightening will be slow.

Conclusion

Monetary policy will be eased further in 2025. The Fed's terminal rate will be debated next year as the Fed needs to gauge the impact of Trump policies on activity and inflation. We see the Fed funds rate bottom at 3.5%. The ECB will ease but inflation is likely to remain sticky due to elevated wage growth. The BoE faces a similar challenge. The BoC and the RBNZ will have to respond to higher unemployment. In Asia, the PBoC will make policy more accommodative to fight deflation whilst the BoJ will cautiously raise rates as inflation stabilizes near 2%.

Axel Botte

Market review

Rate cuts fail to tame long-term yields

Year-end markets experience volatility despite central bank activism.

Bond yields have resumed their upward trajectory, countering the multiple rate cuts implemented by central banks this week. The German Bund yield has climbed above 2.20%, while the U.S. Treasury note has surpassed 4.35% by week's end. Conversely, China's monetary stimulus has led to an 18-bp decline in 10-year yields. Credit markets are cushioning the impact, although some profit-taking has been observed in sovereign bond markets. Chinese equities plunged 2% on Friday amid uncertainty surrounding the fiscal support plan for next year. Notably, the U.S. technology sector remains a standout in equity markets.

As anticipated, the ECB has lowered its rate to 3%, a level that Christine Lagarde no longer considers restrictive for the economy. Monetary easing is likely to continue at the same pace of 25 bps per meeting, barring any significant surprises regarding economic activity. Inflation (projected at +2.1% for 2025) and growth forecasts (projected at +1.1% for 2025) have been revised down slightly. In the US, inflation data remains consistent, with the November CPI showing at 2.7% and core inflation unchanged at 3.3%. While the improvement in rents is encouraging, a return to 2% inflation remains uncertain. Meanwhile, producer prices were accelerating (3.5% excluding food, energy, and trade), and import prices are rising even before potential tariffs from the Trump administration are imposed. Wages have increased by 4.3%, according to the Atlanta Fed. Meanwhile, fiscal support promised by Beijing to stimulate growth remains vague at this stage.

Interest rate markets experienced their worst week since early October. Long-term yields across major markets have risen by 15 to 20 bps, with a resurgence of the steepening trend. The U.S. note is approaching 4.40%, while the Bund has crossed above the 2.20% line. Half of the movement is traceable to higher inflation breakevens driven by a $3 rebound in oil prices and U.S. price data. While a 25-bp cut in the Fed funds rate on December 18 seems certain, inflation data will undoubtedly catch the attention of the FOMC participants. Canadian bond yields also surged despite the BoC's 50-bp rate cut. Conversely, the Chinese 10-year yield has plummeted. JGB yields have stabilized around 1.05%, awaiting a clear signal from the BoJ. The yen (153) has depreciated again against the U.S. dollar. In the euro area, the French spread remains nearly stable at 77 bps following the appointment of François Bayrou as Prime Minister. The spread on Italian BTPs has climbed back above 110 bps due to portfolio adjustments ahead of the holiday season.

The credit market remains well-positioned, with weekly spreads tightening by 2 bps. The iTraxx index is quoted at 53 bps. Some French credits are under pressure due to sovereign linkages, but the overall trend remains favorable. High yield bonds are outperforming, despite the widening of the crossover index following the ECB meeting. European equities lack a clear trend, with interest rate fluctuations negatively impacting utilities and real estate sectors. Portfolios are being adjusted, leading to profit-taking on the winning bets of 2024.

Axel Botte

Main market indicators

G4 Government Bonds	16-Dec-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.04%	+4	-8	-36
EUR Bunds 10y	2.24%	+12	-12	+21
EUR Bunds 2s10s	19.3bp	+7	-4	+58
USD Treasuries 2y	4.24%	+11	-6	-1
USD Treasuries 10y	4.39%	+19	-5	+51
USD Treasuries 2s10s	15.2bp	+8	+2	+53
GBP Gilt 10y	4.43%	+16	-5	+89
JPY JGB 10y	1.07%	+2	-35	-83
€ Sovereign Spreads (10y)	**16-Dec-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	80bp	+5	0	+27
Italy	115bp	+7	-4	-53
Spain	69bp	+5	-2	-28
Inflation Break-evens (10y)	**16-Dec-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	1.95%	+5	-4	-18
USD 10y Inflation Swap	2.47%	+4	-7	+6
GBP 10y Inflation Swap	3.49%	+4	-10	-5
EUR Credit Indices	**16-Dec-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	98bp	-2	-1	-40
EUR Agencies OAS	61bp	+0	+0	-9
EUR Securitized - Covered OAS	57bp	+0	+8	-22
EUR Pan-European High Yield OAS	307bp	-11	-15	-92
EUR/USD CDS Indices 5y	**16-Dec-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	54bp	+1	-2	-4
iTraxx Crossover	299bp	+9	-2	-15
CDX IG	48bp	+0	-1	-9
CDX High Yield	296bp	+2	-12	-61
Emerging Markets	**16-Dec-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	322bp	-9	-2	-63
Currencies	**16-Dec-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.049	-0.719	-0.944	-5.0
GBP/USD	$1.267	-0.807	0.016	-0.5
USD/JPY	JPY 154	-2.033	0.149	-8.7
Commodity Futures	**16-Dec-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$74.2	$2.0	$3.4	-0.3
Gold	$2 651.9	-$12.7	$41.4	28.5
Equity Market Indices	**16-Dec-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	6 072	0.31	3.42	27.3
EuroStoxx 50	4 957	-0.57	3.38	9.6
CAC 40	7 364	-1.55	1.30	-2.4
Nikkei 225	39 457	0.76	2.11	17.9
Shanghai Composite	3 386	-0.48	1.67	13.8
VIX - Implied Volatility Index	14.19	0.00	-12.08	14.0

Source: Bloomberg, Ostrum AM

Additional notes

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