MACROECONOMIC *view*

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How high will interest rates go?

Key highlights:

- Central banks are keeping mum on where their tightening cycles will end (they themselves probably don't know).
- The markets continue to revise upwards their forecasts on terminal key rates.
- Various forces are pushing towards disinflation in 2023, but a return to the 2% target is doubtful.

2022 will go down in history as the year of a global bond crash the likes of which have not been seen in a generation. In the 1994 bond crash, interest rates peaked at a higher level than currently, but the correction was of a lesser extent and speed. By way of illustration, 10-year government bond yields in G7 countries (excluding Japan) soared by 200 bps in 1994. In 2022, we are already up by 280 bps, and the year is not over yet. The 2022 bond crash has caused even more damage as it has occurred after a decade of rate compression (following the 2008 financial crisis and the 2020 pandemic), and in some cases after a period of negative rates. Investors simply forgot that interest rates could rise so quickly. So, are we at last witnessing the end of this correction?

To answer this question, we need to consider three essential parameters for the direction of long-dated government bond yields, namely, the direction of monetary policies, the outlook for growth and inflation, and the risk premium tied to fiscal choices. Here is where each of these currently stands.

The latest decisions by the major central banks have confirmed their ultra-restrictive bias. The Fed, the Bank of England, and the ECB raised their key rates by 75 bps. Since the tightening cycle began, they have tightened their monetary policies by 375, 290 and 200 bps respectively. Central bankers everywhere are flagging other rate hikes but are careful enough not to say where and when the cycle will end. However, they are unequivocal in ruling out the least bit of easing in the short term. In reaction, the markets continue to raise their projections of terminal key rates. These recently were a little above 5% for the Fed, 4.5% for the Bank of England, and 3% for the ECB (chart).

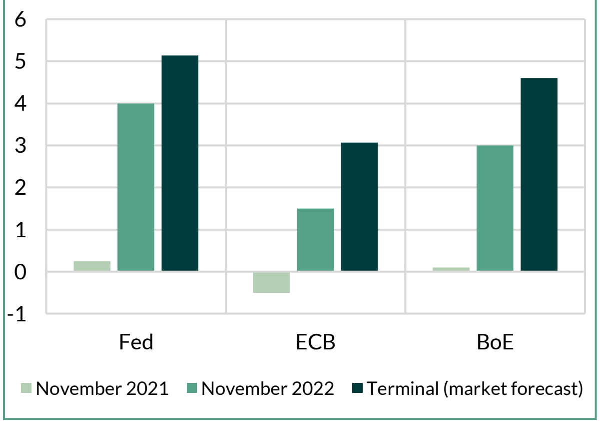
As we approach these levels, the pace of future rate hikes is likely to slow in the coming months. At the start of the tightening cycle, central banks hastened to make up lost ground and to adjust their mistaken inflation forecasts. This is no longer as necessary. Although they have not yet beaten inflation, we cannot doubt their determination to restore price stability, in accordance with their mandate. After all, they are willing to "sacrifice" demand and jobs in order to ease price and wage pressures. In short, the direction of monetary policies continues to push long-term bond yields upwards.

Apart from monetary policies, interest rates are meant to reflect the nominal economic growth, combining increase in volumes of economic activity and prices. **Regarding the outlook for economic activity, revisions continue to point downwards.** The consensus currently projects an average real GDP growth of about 0.5% in 2023 in the United States (-2 percentage points since January), 0% in the euro zone (-2.5 points), and 4.8% in China (-0.5 point). **In all cases, these growth paces are far below potential trend rates.**

Regarding prices, the general view is that inflation will slow sharply in 2023 after hitting historic highs this year at close to 10% in most developed countries. Disinflation factors are becoming more numerous, including the easing of global logistics disruptions, weaker demand for manufactured goods, the end of Covid support schemes, receding in the prices of many commodities and, most of all, the negative shock to real income. The one missing link in the disinflation scenario, particularly in the US, is wage moderation. In 2022, inflation statistics continued to surprise upwards, encouraging the concept of a change of paradigm and the risk of galloping inflation, as in the 1970s. This helped cause a spike in long-term bond yields. That being said, we wouldn't be surprised if things played out in the other direction in 2023, something that would change the inflation shock "narrative".

As for fiscal policies, a few weeks ago, the markets imposed an exceptional risk premium on UK government bonds, fearing an unsustainable widening in its fiscal deficits. Most of the damage from this episode of market stress has since been erased but this required a complete about-face in fiscal choices. **Higher interest rates have made servicing of public debt more expensive just as central banks have halted or scaled back their asset-purchasing programmes.** With this in mind, fiscal policies must avoid raising the slightest doubt on the sustainability of public finances; otherwise, they risk seeing their yields spike further. The UK example is instructive for all other governments, both those with very heavy debt load (Italy) and those whose fiscal process is sometimes held hostage by partisan bickering (the United States).

POLICY RATES OF MAJOR CENTRAL BANKS (%)



Source : ODDO BHF Securities, Bloomberg

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