MUFG Asset Management

Global Fixed Income Thematic Viewpoint

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18 MARCH 2024

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Divine Influence, r-star and US Interest Rates – where will they settle?

In short, no one knows. In reality, the level of the 10-year interest rate is determined by the level that market participants are satisfied with and what level the economy will tolerate (in other words, whether it balances the risk of inflation or economic recession). The latter will be led by the Federal Reserve, and the former will be decided based on the situation or position that market participants are satisfied with.

Based on experience of previous governors, markets have, at times, been unconvinced by the Fed's explanations and commentary. Through forward guidance, the Fed communicates the likely future course of interest rates and the factors that influence their thinking in decision-making. For example, if mortgage rates fall, the number of loan applications increases, or consumption increases, the Fed will look for signals from the economy that "it is not yet time to cut interest rates". Senior officials will issue statements that are more cautious and the market adjusts its level accordingly. This process will likely determine long-term interest rates and not some divine influence in the bond market, or the idea that the bond market is smart enough to account for factors not realised by broader society.

In reality, bond yields are used as a standard to determine the appropriateness of prices that the economy will tolerate. Therefore, bond market participants are said to be smart because they can more easily reflect macroeconomic conditions than other assets. Stocks, on the other hand, are valued at around 20 times corporate earnings, so levels are easily moved based on expectations and news flow - including the AI boom. This leads us to mention the view that 70% of a stock's price movement is caused by interest rate levels and 30% by company earnings, speculation and investor dreams.

Now to the question of where US interest rates are likely to settle down. In short, it should be around 4% - if supply and demand dynamics remain reasonably balanced. Currently, the demand side of the equation is strong, so a level over 4% would seem appropriate. Therefore, when the rate falls below 4%, personal consumption and stock prices strengthen as mentioned in the previous section, mortgage rates approach 6%, and the number of applications for mortgages increases. This sounds like the economy is saying, "It's not yet time for a rate cut". For the stock and housing markets, this level is a neutral level that neither heats nor cools the economy.

To explain the above estimate we can use clues from potential growth rate. The potential growth rate announced by the U.S. Congressional Budget Office on 7th February for 2024-28 was raised to +2.2% - largely due to strong immigration. From 2029 to 2034, the forecast is for a decline of around 1.9% due to an aging population partially offset by improvements in productivity. The potential growth rate is calculated from a country's supply capacity, so if supply and demand are relatively balanced, real GDP will be around 2%. Adding 2% inflation to this figure results in nominal growth of around 4%. In this situation, if the interest rate were to be 3%, it would be better to borrow money at 3% and buy an asset that can express nominal growth of 4%, that is, a stock market index, so the asset price rises, stimulating demand. Therefore, our view is that this level is around 4%. We saw the strength of the current annual real GDP growth rate in the third quarter of 2023 despite Fed Funds rates at the elevated level of 5.5%. This is the key reason why the Federal Reserve could not decide to cut interest rates.

Next is the real neutral level model announced by the New York Fed on 1st March. There are two models, and without getting into detail, the Q4 2023 figure of 1.12% has recently fallen sharply to 0.84%. This model reflects the gap between demand and supply and would suggest a lower r-star (natural or neutral interest rate level) with demand and supply balance easing. This is in contrast to the current positive economic trend and the potential growth rate discussed earlier. As a result, we believe the model underestimates the actual real natural interest rate level.

There are other reasons to be cautious when using this model for predicting monetary policy. Because the economy can no longer be explained entirely by cyclical movements due to shocks like coronavirus and geopolitical events, the accuracy of these models has decreased considerably. Based on the above and looking at recent economic data, there is even a possibility that the Fed may not cut interest rates at all this year, or it may be a one-off event influenced by politics. As we have previously discussed, the market is abuzz anticipating the timing of rate cuts but we continue to believe that caution is still required.

Important Information