Fixed Income Monthly

Research | 15 February 2024

- **Markets continue to cut expectations for an early (March) rate cut by the Federal Reserve.**
- **Economic data continues to perform ahead of expectations while Fed speakers have pushed back on cutting rates too quickly.**
- **Regional economies have cooled at the start of the year but activity indicators still suggest robust non-oil activity. Both Egypt and Turkey hiked rates at the end of January to grapple with still high inflation.**

Global macroeconomic developments

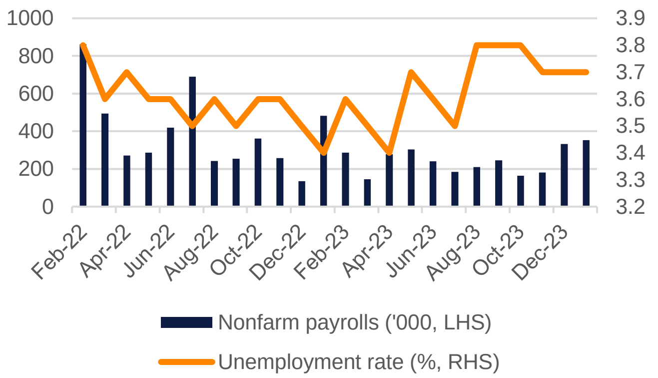
The FOMC kept rates unchanged at the FOMC meeting ending January 31, holding the Fed Funds rate at 5.5% on the upper bound. The statement was revised to say that "economic activity had been expanding at a solid pace" and that the risks around its "employment and inflation goals are moving into better balance." More explicitly, the FOMC stated said that it "does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent."

In his press conference after the meeting, Fed chair Jerome Powell said that he didn't think the FOMC would have that "level of confidence by the time of the March meeting," pushing against market expectations that a rate cut could happen as early as March. He also said that the Fed was "prepared to maintain the current target range...for longer if appropriate." Chair Powell also noted that it was a "highly consequential decision to start the process" of easing rates and the Fed clearly doesn't want to risk having to hike rates if inflation fails to sustainably decline.

Supporting expectations that the Fed doesn't need to move as early as March was a strong non-farm payrolls print for January. US nonfarm payrolls surged higher in January, gaining 353K, significantly higher than consensus expectations for a 185K rise. The January report from the Bureau of Labor Statistics also showed a material upward revision to the December figure, rising to 333K from an initial estimate of 216K. The latest rise in payrolls was broad-based, although health care and government continued to make large contributions to the total. The unemployment rate remained unchanged at 3.7% for the third consecutive month.

Average hourly earnings also rose sharply, gaining 0.6% m/m and 4.5% y/y, in a move that appears at odds with other measures such as the quarterly employment cost index. It is possible that unseasonable weather has affected the latest prints, with response rates in both December and January well below average. Regardless, the January data is likely to strengthen the Fed's argument in favour of holding rates at their current levels.

US labour market outperforms in January

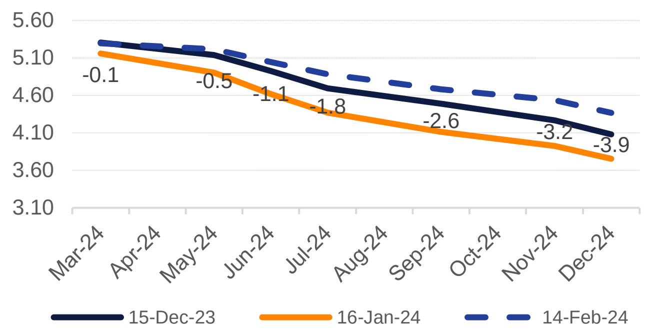


Source: Bloomberg, Emirates NBD Research.

The January CPI inflation report for the US came in faster than expected and pushed back further on market expectations of imminent rate cuts. The headline CPI index dropped to 3.1%, down from the 3.4% recorded from January but ahead of market expectations of a dip to below 3%. On a monthly basis the CPI index rose by 0.3%, the fastest pace since September 2023.

Core inflation was steady at 3.9% y/y but was up 0.4% m/m, actually its fastest print since May last year, while super-core inflation, which strips out energy, food and housing costs rose 4.3% y/y. To be clear, PCE inflation has been running at a lower pace—the headline index held steady at 2.6% for December while on some measures the core PCE deflator is already running below the Fed's 2% target level.

Changes in Fed Funds pricing



Source: Bloomberg, Emirates NBD Research

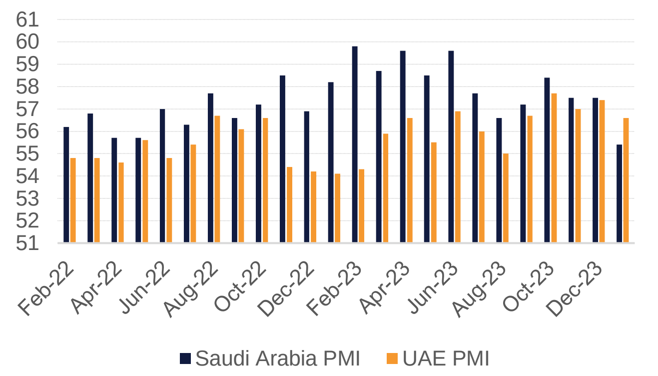
Chinese consumer price inflation fell 0.8% y/y in January, the fastest pace of decline since 2009. The decline was larger than the 0.5% fall that had been expected, and sharper than the 0.3% y/y drop seen in December. Producer prices also remained in deflationary territory, falling for the 16th consecutive month. Falling prices underscore the current weak state of domestic demand in China, which is struggling under a continuing property market crisis.

The European Central Bank kept rates unchanged at its first meeting of 2024, holding the deposit facility at 4% after 200bps of hikes in 2023. The ECB noted that the "declining trend in underlying inflation" is continuing while "tight financing conditions" are also helping to cool inflation. The bank said that risks to economic activity were "tilted to the downside" but gave a more balanced outlook on the risk to inflation in 2024. ECB president Christine Lagarde said that there was consensus in the ECB governing council that it was "premature" to begin discussing rate cuts and that she stood by comments made earlier in January that rates would move lower in the summer. Lagarde didn't commit to a specific timing for rate cuts saying that the ECB would "continue to be data-dependent" rather than "date-dependent."

Regional economic developments

The S&P Global PMI survey for the UAE fell to 56.6 in January, down from 57.4 the previous month. This marked a five-month low for the headline index, although it remains a strongly expansionary reading for the non-oil private sector. Output was also at a five-month low, but over a fifth of firms still saw an expansion in activity, with government projects cited as one driver of growth. The pipeline for the coming months remains positive as new orders growth was strong even as it slowed slightly from the December level. The domestic market continues to drive new order growth as new export orders expanded at a far slower pace with only a marginal expansion for the second month running.

GCC PMIs show robust performance



Source: Bloomberg, Emirates NBD Research

There was also a slowdown in Saudi Arabia's non-oil private sector at the start of the year as the Riyad Bank PMI survey fell to a two-year low, dropping to 55.4, from 57.5 the previous month. This is still indicative of strong growth, and output continued to expand quickly, but this was also at the slowest pace since January 2021. Firms noted ongoing projects and a rise in tourism as helping to boost activity. However, there was a sharp drop in new orders compared with the previous month with firms noting increased competition in particular as having weighed on growth. As with the UAE, it is domestic orders that are driving the expansion and in Saudi Arabia, as new export orders contracted in January.

The Central Bank of Egypt hiked its benchmark interest rates by 200bps at its first meeting of 2024, taking the overnight deposit rate to 21.25%. This was the first time the bank had hiked rates since August, and confounded expectations of another hold by the bank. However, the tightening of policy is likely another indication that a new agreement with the IMF around the exchange rate and an enlargement of the support programme is near, after reports of intensified discussions. In its communique, the bank highlighted that monthly inflationary dynamics had been greater than anticipated, with fiscal consolidation measures and supply side pressures contributing, along with elevated broad money growth. It also noted the risks stemming from 'geopolitical uncertainty and ongoing maritime trade disruptions.'

Egypt's headline CPI inflation slowed to 29.8% y/y in January, down from 33.7% the previous month. This marked the slowest pace of annual price growth since last January, with base effects from EGP devaluations passing through helping to bring it down. On a monthly basis, price growth accelerated to 1.6%, from 1.4% in December, with the CBE noting ongoing pressures on the monthly measure when it implemented its surprise 200bps hike last week. The government has also recently announced a 50% increase to the minimum wage for public sector workers which could further stoke inflationary pressures.

Turkey's central bank raised the benchmark 1 week repo rate by 250bp to 45% as expected on January 25. The statement indicated that rates have likely peaked but would be maintained "until there is a significant decline in the underlying trend of monthly inflation and until inflation expectations converge to the projected forecast range." The central bank expects inflation to fall to peak around 75% before easing to 36% by year-end. Updated forecasts are expected in February.

Turkish inflation accelerated sharply in January, reaching 6.7% m/m, the fastest monthly price gain since August, up from 2.9% m/m in December. On an annual basis inflation rose to 64.9% in January, from 64.8% y/y in December, above the consensus prediction of 64.6%. The services sector in particular saw strong rises as health and hospitality prices rose swiftly. Core inflation was up 4.1% m/m and 70.5% y/y. A new central bank governor, Fatih Karahan, has been appointed after Hafiz Gaye Erkan's departure. Karahan made a statement on Sunday where he said that the TCMB's focus would be on getting inflation under control. Along with the upside surprise in January data, this potentially leaves the door open to further hikes in the one-week repo rate.

Fixed Income – Market Data

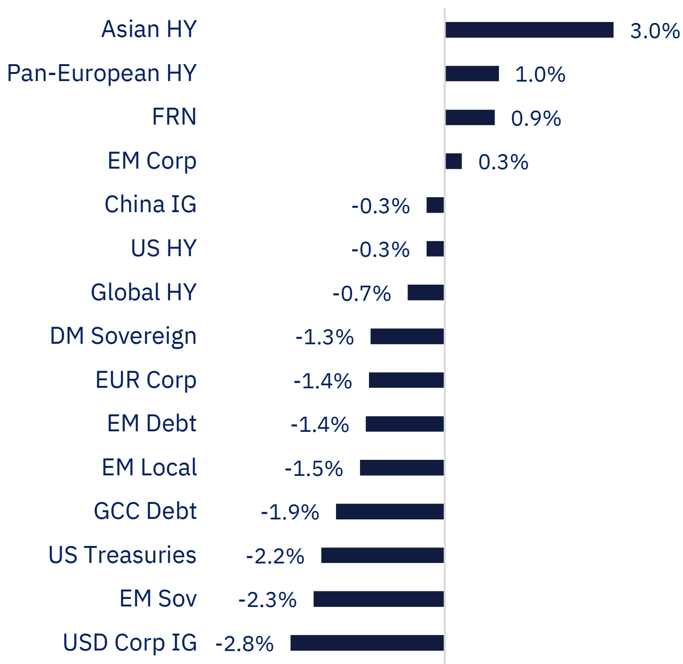
January gave a sense of déjà vu. In October last year, the narrative on fixed income changed post the Quarterly Refunding Announcement of the US Treasury and the subsequent dovish turn in the Fed FOMC meeting. January had seen a similar uptick in yields as the aggressive rate cuts priced in got phased out. From 157 bps rate cuts priced in for FY 24 on 29th December, we are down to 93 bps or less than four rate cuts as of 14th February. Rate cut probabilities for the May FOMC meeting have dropped to one-third probability post hawkish Fedspeak and robust macro data prints from the US.

The US Treasury yield curve has massively bear-steepened. The benchmark 10-year yields have increased by 43 bps to touch a YTD high of 4.3%. The front-end 2-year yields have also increased as a response to the "higher-for-longer" paradigm gaining ground to trade above 4.6%. The US Treasury held coupon note auctions in the first week of February that went on smoothly after the recent uptick in yields. In fact, for the 10-year auction, USD 37.5bn was awarded to end users, the second highest on record. Across the Atlantic, the yields of UK Gilts and German Bunds have also increased with a slight difference. In both of these instances, the belly of the curves (3 to 5 years) has seen the highest increases in yields.

Credit spreads continue to grind tighter across different segments. Investment Grade (IG), High Yield (HY), and Emerging Market Debt OAS spreads currently trade near their bottom quartile. The compression continues in the face of near-record IG bond issuance in January. The new issue premium offered dropped drastically as investor demand grew.

Within GCC, we saw more than USD 25bn bonds issued so far this year compared to USD 62bn of hard currency bonds issued last year. KSA sovereign has been the largest issuer, pricing USD 12bn bonds across three tranches in January. Historically, February has been a lousy season for spreads. We see mounting risks to tight valuations heading into February, including geopolitics, seasonality, and any surprises to the Goldilocks assumptions built into the market's current expectations.

FI Index return w/e Feb 14, ytd



Source: Bloomberg

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