CIO expects rates to come down in 2024, supporting both equity and bond markets; the speed of recent gains is likely to moderate. (UBS)

Markets pricing in good news on inflation and rates

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The S&P 500 ended Monday at its highest level in 20 months, leaving the index up more than 20% for the first time in 2023. The US Treasury market has also been holding onto recent gains.

The yield on the 10-year Treasury edged lower on Monday to 4.2%, down from a 16-year high struck in late October.

Behind the positive sentiment is the expectation of continued good news on inflation that would allow central banks to bring rates lower swiftly in the new year. The extent of this enthusiasm will be put to the test this week with the release of the US consumer price index (CPI) for November, along with policy decisions from both the Federal Reserve and the European Central Bank.

We continue to expect a benign macroeconomic outlook heading into 2024. But with so much good news already priced in, there is a risk that even modest disappointments could lead to market volatility.

Investors will be looking for further good news on US inflation to offset recent concerns over the continued strength of the labor market. Confidence had started to build that employment conditions were easing gradually, removing a major impediment to Fed rate cuts for 2024. This optimism was dented by data on Friday pointing to more robust job creation than had been expected in November, while unemployment fell back to 3.7% from 3.9%.

So, investors will be hoping for reassurance from today's inflation data that price pressures are easing sufficiently to justify decisive Fed rate cuts next year. The consensus forecast is for headline annual inflation to slow to 3.1% for November, from 3.2% in the prior month and a peak of 9.1% in June 2022. Economists expect the core rate, excluding food and energy, to hold steady at an annual 4% while the monthly rate accelerates slightly to 0.3% from 0.2%. Any positive surprises will likely provide support for the recent rally in both bonds and stocks. Equally, markets could be sensitive to an outcome that is above these projections.

The Fed's policy meeting on Wednesday comes against a backdrop of ambitious market assumptions about the pace of easing next year. Earlier in the month, markets were pointing to around five 25-basis-point cuts over the course of 2024, starting early in the new year. Such expectations have been scaled back in the wake of the November employment report. However, markets are still implying around four rate cuts, with a roughly 50/50 chance of the process getting under way by the March meeting. That looks too optimistic, in our view, setting the market up for a potential disappointment based on the Fed meeting. Aside from the tone of Fed commentary, the key focus is likely to be the dot plot, which charts the rate expectations of top officials.

The ECB could also seek to push back against market expectations for the speed of rate cuts at its meeting on Thursday. As with the Fed, investors are bracing for a roughly 50% chance of a rate cut as early as March—with between 100 and 125 basis points of easing for the year overall. Although this is down from a peak of around 150 basis points over the year, this still looks excessive to us, and we are projecting 75 basis points of cuts. President Christine Lagarde could take the meeting this week as an opportunity to reinforce her inflation-fighting credentials by adopting a more hawkish tone. In addition, if business activity survey readings, released later this week, are stronger than expected, this could cause the market to further scale back expectations for lower borrowing costs in 2024.

So, while we expect rates to come down in 2024, supporting both equity and bond markets, the speed of recent gains is likely to moderate. In particular, we now only see modest upside for global and US equities. With economic growth set to slow, quality stocks are likely to outperform in our view. We remain most preferred on quality bonds, and we expect the yield on the 10-year US Treasury to end 2024 at 3.5% compared to around 4.2% at present.

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