Higher interest rates for longer

The final weeks of the third quarter of the year confirmed the asymmetric slowdown in the world economy, with strong signs of cooling in Europe, a less marked adjustment in economic activity in the US – thanks to the strength of US consumption – and significant doubts over the performance of the Chinese economy despite the recent improvement in its activity indicators. As we enter an autumn in which the effects on growth of the recent monetary tightening will intensify and the mini supply shock of the rise in oil prices in recent months will have to be digested, economic agents' expectations continue to deteriorate, anticipating a weakening of demand in the short term.

In this context, with clear symptoms of economic cooling and the central banks' rate hikes nearing their conclusion, there has been a sharp rise in yields throughout the curve. This has included movements as significant as an almost 100-bp increase in the yield on the US 30-year bond, placing it close to the peak of 2007 (4.95% versus 1.2% in the summer of 2020), a new uptick in the Italian risk premium towards the 200-bp mark (trading 50 bps above that of Greece), a rise in real yields (2.3% in the case of the US inflation-indexed 10-year bond) and a widening of corporate fixed-income spreads, especially in high-yield segments, where the cost of financing is close to 9%.

We are thus entering a phase of heightened market sensitivity and discrimination, now that the central banks are managing to convey the message that interest rates will remain higher for longer, which will lead to extreme caution in the fiscal sphere. The case of Italy is a new warning for sailors, as the rise in yields to the 5% zone coincides with the new budget proposal, which includes a marked deterioration in the fiscal deficit estimates for 2023 (5.3%), 2024 (4.3%) and 2025 (3%).

Meanwhile, in the US much of the rebound in interest rates is explained by an increase in both real returns and the risk premium, since no changes in inflation expectations are detected. This reflects the challenging political context and very high short-term funding needs (7.6 trillion dollars in 2024). Yet despite the choppy waters of the current global economic and financial environment, the dollar has been the financial asset most favoured by the latest adjustment in the monetary narrative, appreciating significantly to trade below 1.05 against the euro (+6% since July) and touching the 150-yen mark against the Japanese currency (its highest level since 1990). All this reflects the fact that, in spite of the problems in the fiscal and political sphere, investors value the relative strength of the American economy, the attractiveness of the highest returns in a decade and a half, and the traditional safe-haven role of the US dollar.

This weakening of the euro against the currency used to pay for energy, just at a time when the price of crude oil is once again under stress, is not good news for an ECB which already has its work cut out for it over the coming months, as it will have to keep in check investors' expectations that are increasingly dependent on the data, as well as respond to any sources of financial instability and manage the effects on economic activity of the most intense monetary tightening process in recent decades. The key in the short term will be what happens with the second-round effects caused by feedback between business margins and wages and, therefore, the negative inertia which can occur at times like the present if economic agents decide to maximise their short-term returns. For now, beyond the noise in the data caused by fluctuations in the oil price, there are encouraging signs coming from the underlying measures of inflation in the euro area in recent months and it appears highly probable that the 3% zone can be reached during the next semester.

In short, the movement in the financial markets of recent weeks serves to consolidate the sensation that the interest rate regime will regain a degree of normality in the medium term, following the anomaly in the pattern of monetary policy in much of the last decade. This will mean higher real or equilibrium natural rates of interest than we have had in recent years.

José Ramón Díez