Macro Talking Points

Fixed Income Insights

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In brief

- **Reviewing the big consensus forecasts for 2025**
- **The Fed meets and we are going to watch the Dots**
- **Canada remains a potential fixed income sweet spot**
- **The outlook for MBS is turning positive**

Looking into the 2025 crystal ball. As we wrap up 2024, it's useful to review key consensus projections for next year. To be clear, consensus numbers should only be used as a reference, and their significance should not be overstated. Starting with the US macro-outlook, the Bloomberg consensus forecast suggests that inflation will continue to slow down, with core PCE, the inflation measure targeted by the US Federal Reserve, projected to close 2025 at 2.2% year over year.[1] On the growth front, GDP will continue to grow at about 2% throughout the year, indicating no trouble. On the rates side, consensus currently has the federal funds rate closing next year at 3.7%, a tad lower than is implied by the rates market. As for the 10-year segment, the Bloomberg consensus has the US 10-year at 4.1% in December 2025, or roughly 30 basis points lower than where we are right now. Away from the US, the consensus forecasts for Europe are quite a bit gloomier: virtually no economic growth, with the consensus at around 0.3% throughout the year. Eurozone inflation, meanwhile, stays in the box, at 2%, and the European Central Bank is projected to lower its policy rate to 2.15%. Given the challenges that the region faces, that could too conservative. Indeed, our DM rates research team is calling for an ECB terminal rate of 1.75%. At least, based on these forecasts, this confirms our view that 2025 could be a year of great bifurcation between the US and Europe.

Walking the tightrope. Or more specifically the dotted line. The Fed meets this week for the last policy meeting of the year, and it's going to be all about the dot plot, which illustrates the forecasts of FOMC members. Will the dots signal fewer rate cuts than in the September update? While a 25 bp rate cut is virtually a done deal, the big risk at this FOMC is how hawkish a shift the Fed will signal through its communication? Talking to our chief economist, Erik Weisman, the hawkish scenario would be that the Fed validates current market pricing and basically admits that, yes, you are right to have priced out all these rate cuts. In contrast, the more bullish scenario for duration would be the Fed signaling that market pricing has gone too far. Beyond the near term, the question of where the Fed will land remains essential. Nobody really agrees about where the Fed's neutral rate is, but the reality is that the long-term rate, as disclosed by the Fed through its long-term median dot, has been creeping up. Separately, it will be interesting to watch whether Fed Chair Jay Powell hints at the potential impact of Trump 2.0. Overall, we feel the backdrop for US duration is not as favorable as it was just a few weeks ago.

The epicenter of fixed income Goldilocks is still north of the border. After the Bank of Canada delivered an aggressive 50 bp rate cut, our fixed income team remains constructive on Canadian fixed income, where many of the factors are positive. Talking to Canadian fixed income portfolio manager, Soami Kohly, the BoC is likely to cut its policy rate all the way down to 2.75%, or perhaps even lower, if the macro backdrop deteriorates further. In other words, the risk to rates is skewed to the downside. This means that there is a lot more easing in the pipeline, which is always a good thing for fixed income. In Soami's view, the BoC may not be as aggressive going forward, but it will likely be steady and committed to maintaining an easing bias in the period ahead. On the credit side, the valuation backdrop remains favorable, with Canada spreads more attractive than their US peers. Overall, we feel on the global fixed income map, Canada — perhaps along with the eurozone — could be a good place to be.

Constructive view on agency MBS. Prospects are looking up for MBS. Talking to our fixed income portfolio manager in charge of the securitized portfolios, Jake Stone, there are reasons to be more optimistic about the asset class in the period ahead. For a start, rate volatility has corrected lower, with the MOVE index now well below 100, always a supportive factor. On the valuation front, the backdrop is also favorable, especially when one looks at MBS on a relative-value basis against corporate spreads. More importantly, the technical picture, after looking quite poor for some time, now appears more promising. This is mainly because the banking sector no longer actively participates in the asset class, because of the mini-banking crisis last year, but our investment team believes that this may change going forward. In other words, the demand may bounce back in a major way as the financial sector's risk appetite returns. Finally, MBS fundamentals remain adequate. Overall, agency MBS may be well positioned to outperform many of its peers in 2025. ◢

Endnotes

[1] Sources: Bloomberg. All the consensus forecasts quoted in this section represent the current Bloomberg consensus forecasts for end-2025. Consensus data as of 16 December 2024.

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