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Monthly economic outlook for Private Equity

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Rates on the rise

Despite most major central banks cutting their short-term policy rates, longer-term rates are rising. For example, the Federal Reserve Bank (Fed) has cut the federal funds rate by 100 basis points since September. Over that time period, the yield on the 10-year treasury bond has increased by 120 basis points.[i] As of 13 January, it reached 4.8%. Apart from a few days in 2023, that is the highest rate since 2007.

The rise in longer-term interest rates has not been limited to the United States. The yield on 10-year gilts jumped to 4.9% on the same day, the highest rate since 2008. The yield on 10-year government bonds increased in Canada, Australia, Japan, and throughout most of Europe.[ii] With the exception of Japan, the central banks in all these countries have been cutting interest rates and indicating that additional cuts are on the horizon.

Why are we seeing long-term bond yields rise in this environment?

Much of the dynamic is emanating from the United States. Although the Fed cut rates as recently as December, it has indicated that the pace of future rate cuts will be slower than they had expected in September. Indeed, the median forecast from the September Federal Open Market Committee meeting had 100 basis points of cuts in 2025. By December, the median forecast had been pared back to just 50 basis points.[iii] This change in expectations for short-term rates applied upward pressure on long-term rates.

In addition, the United States economy continues to beat expectations. Notably, the December payroll numbers were much stronger than consensus estimates, which caused many investors to doubt that the Fed will be able to cut rates at all in 2025. The possibility of tax cuts, tariff increases, and the new administration’s immigration policy put upward pressure on interest rates as they are seen as inflationary policies.[iv] The implementation of tariffs in the United States historically leads to a stronger dollar. That in turn will make currencies weaker elsewhere, putting upward pressure on inflation and interest rates in those countries.

It is important to note that the upward momentum in rates is not solely due to conditions in the United States. Euro area inflation accelerated at the end of last year, and core inflation has been stuck around 2.9% since March 2024.[v] Inflation in the United Kingdom has followed a similar trajectory, though inflation runs hotter there.[vi] Persistent inflation has raised concerns that these central banks may need to slow the pace of their interest rate reductions.

Fiscal deficits are also quite large in several European countries. In 2023, the fiscal deficit as a share of GDP was 7.2% in Italy, 6.0% in France, and 5.7% in the United Kingdom.[vii] For context, European Union countries are supposed to keep their deficits below 3% of GDP.[viii] Such fiscal imbalances raise the risk premium for government bonds in these locations.

Many of these countries are also attempting to reduce their deficits. However, the rise in interest rates will make that more difficult. Higher interest expense will require more revenue or fewer expenditures to meet deficit targets, which could restrain economic growth. Bond markets moved against the United Kingdom in 2022 when policymakers intimated that they would expand their budget deficits.[ix] More recently, policymakers in the United Kingdom gave themselves a slim margin to achieve their fiscal rules when they presented their autumn budget.

Last year, France's government was toppled over a budget dispute.[x] Now the new Prime Minister will have to provide a budget under even less favorable financing conditions.

Although we still expect additional rate cuts this year in the United States, Euro area, and United Kingdom, longer-term rates may remain elevated. Cuts to short-term interest rates will likely be slower than anticipated, especially in the United States where loose fiscal policy is expected to dominate monetary policy, forcing central banks to abandon their planned rate cuts. In addition, an already-strong United States dollar will likely become even stronger if the United States moves forward with tariffs. This could exacerbate inflationary pressures in Europe, limiting cuts to short-term rates there as well.

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Endnotes

[i] Federal Reserve Board via Haver Analytics
[ii] Tullett Prebon Information via Haver Analytics
[iii] Federal Reserve Board via Haver Analytics
[iv] https://www.piie.com/blogs/realtime-economics/2024/how-will-trumponomics-work-out
[v] Statistical Office of the European Communities via Haver Analytics
[vi] UK Office of National Statistics via Haver Analytics
[vii] Government statistical agencies via Haver Analytics
[viii] https://www.consilium.europa.eu/en/policies/excessive-deficit-procedure/
[ix] https://www.bloomberg.com/news/articles/2025-01-09/uk-bond-turmoil-gives-labour-nightmare-of-britain-s-1976-debt-crisis?sref=TtzswLLC
[x] https://apnews.com/article/france-prime-minister-bayrou-budget-4db40ba3b61cf2c2360e3d4ecf3b79ec