Allianz Trade

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What to watch: Higher for longer reloaded in the US, EM financial markets feeling the pinch and the link between inflation and elections

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Executive summary

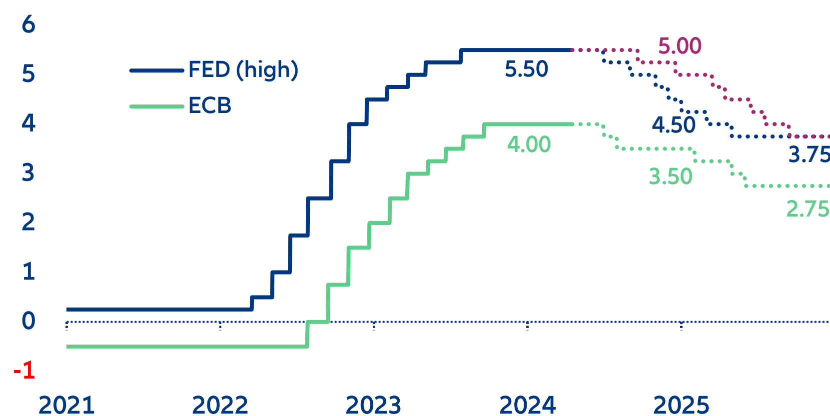
This week, we look at three important issues:

- **US long-term yields: Higher for longer reloaded.** US 10y government bond yields have risen above 4.6% amid expectations of a slower rate-cutting cycle by the Fed, which recently admitted that inflation is taking longer to return to target. But even if the Fed implements only two rate cuts this year – down from our initial expectation of four – we would still expect long-term yields to correct downward from current levels. Market pricing for terminal rates is significantly above our estimates and therefore poised for a downward adjustment, which will drag long-term yields down as well.
- **EM financial markets - fasten your seatbelts.** Risks of a delay in Fed rate cuts are casting a shadow over emerging markets, which have faced heightened volatility and currency depreciations. As a result, EM central banks are caught between a rock and a hard place, unable to deliver the amount of rate cuts anticipated just a month ago. This shift pushed up sovereign bond yields, surpassing our year-end expectations, although spreads in hard currency bonds remain tight. Going forward, we expect a gradual decline in yields in line with major bond markets (which should end the year close to 6% vs. current 6.7%), but a slightly upward movement in hard currency spreads (to 225bps from 200bps in our main benchmark). While this picture may in principle present some opportunities, we remain very cautious as downside risks have also increased.
- **Inflation and election results: There is no nexus.** Looking at 107 elections in 63 major developed and emerging markets since 2021, we do not find that inflation has affected election outcomes. At best, there is a moderate advantage for opposition candidates or parties to win if inflation was significantly higher shortly before the election. Moreover, in the 53 elections in which the latter was the case, a significantly more populist president or government was elected in only six cases at best. However, this group includes significant economies such as Argentina, Italy and the US.

US long-term yields: Higher for longer reloaded

Long-term interest rates in the US have surpassed 4.6% as the chances of the Fed staying higher for longer have risen again. After three consecutive upside inflation surprises, Fed chair Powell admitted last week that it is taking “longer than expected” for inflation to return to target. This is bringing back painful memories of 2022, when Powell admitted that sky-rocketing inflation was not transitory after all, or Q3 2023, when the higher-for-longer mantra emerged for the first time. Now, reflationary worries have not only once again led to a strong sell-off in long-term yields (more than 70bps year-to-date) but have also significantly delayed rate cut expectations. Even though leading indicators such as service sector input costs point to easing price pressures, there is a risk of fewer cuts by the Fed than we initially expected. Figure 1 shows an alternative scenario revising our long-held call of four consecutive rate cuts starting in July to only two cuts this year: the first one being in September and the second in December.[1] These 50bps of cuts in 2024 would then be followed by 125bps of cuts next year, ending at the same terminal rate of 3.5-3.75% as previously expected. For the ECB, we would stick to our March call of only two rate cuts this year, followed by four next year and a terminal rate of 2.25% to be reached by 2026[2].

Figure 1: Allianz Research baseline monetary policy expectations and alternative Fed path (purple), in %



Sources: LSEG Datastream, Allianz Research

However, market pricing for terminal rates is still higher than our expectations and is poised for a correction, likely dragging long-term yields down, too. Figure 2 shows the recent moves of 10y government bond yields and market expectations for terminal policy rates – both for the US and the Eurozone. Even without statistical analysis, it is obvious that expected terminal rates and long-term yields move hand in hand currently. In fact, the delta between the US terminal rate and the 10y treasury yield has been hovering in a narrow range around 60bps for about a year now. As markets are now pricing a terminal rate above 4.1% – up from 3.2% at the beginning of the year – the 10y yield has also increased from 3.9% to 4.6%. The current market pricing of the Fed terminal rate is now clearly above our estimate. We still see the Fed lowering its policy target range to 3.50-3.75% over the next two years, even under our revised monetary policy path. Given the Fed’s own estimate for the neutral rate at 2.7%[3] our terminal rate expectation is still on the hawkish side. Notably, the Fed’s actual policy rate has mostly been below the neutral rate for the past decades[4]. Therefore, we are quite positive that when looking through the current volatility of economic data, both long-term yields and the terminal rate are set for a correction, with the 10y yield approaching a level around 4.1% over the year.

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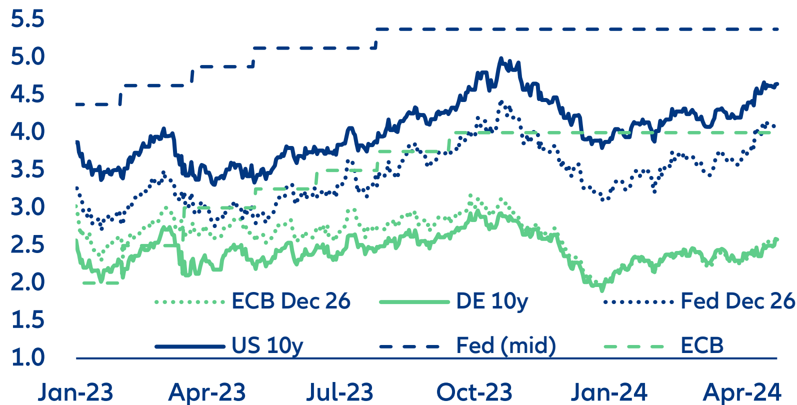
[1] This track implies a pause in November for good reason. The November Fed meeting is just two days after the US election.
[2] See our report [What to watch 11 April 2024](#).
[3] The Fed’s Holsten-Laubach-Williams estimate of the neutral real rate currently stands at 0.7%. Adding the inflation target of 2% gets you to a neutral nominal rate of 2.7%. Alternatively, looking at the Fed’s dot plot, the longer-term median dot stands at 2.56% with even the most hawkish dot at 3.75% being significantly below current market expectations.
[4] See Figure 2 in [What to watch I 11 April 2024.](#)

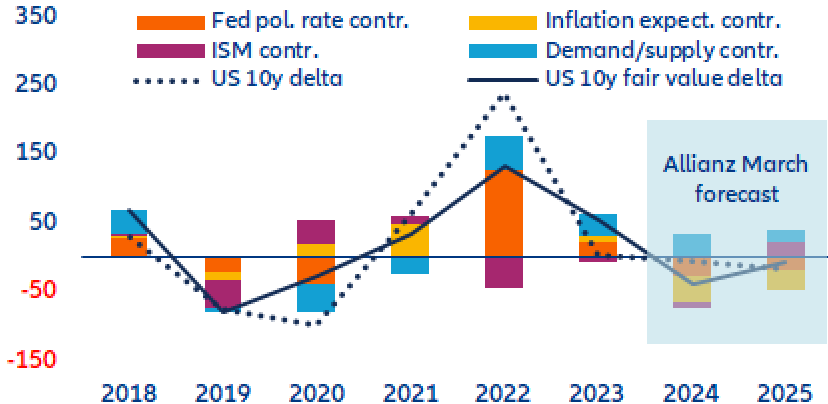
Figure 2: Long-term government bond yields and terminal rate market expectations.



Sources: Bloomberg, Allianz Research
Notes: Terminal rates are derived from money market futures for the end of 2026.

Structural drivers also point to a correction. Figure 3 shows the contributions to the annual changes of our fair value forecast for US 10y yields[5]. We estimate the fair value will drop from 4.1% at the end of 2023 to 3.7% and 3.6% in 2024 and 2025, given policy rate cuts of 100bps this year and 75bps next year. Normalizing inflation expectations are another important driver, adding downward pressure, while the growing demand and supply imbalance of bonds acts as a counterforce given the large US fiscal deficit and ongoing quantitative tightening. If we apply our revised outlook of only 50bps of cuts this year and 125bps of cuts next year, as well as a slightly slower normalization of inflation expectations amid more sticky inflation, we would still expect to see the fair value at around 4.0% at the end of this year and 3.9% at the end of next year. These estimates are also well below current levels and market-implied forward rates.

Figure 3: Allianz Research fair value model contributions to changes in long-term interest rates, in bps



Sources: LSEG Datastream, Bloomberg, Allianz Research

Overall, we are moderately positive on duration at current yield levels in the US but more cautious in the Eurozone where we see less mispricing both for terminal rates and German 10y yields. We anticipate lower long-term interest rates in the US no matter if we look at terminal rate pricing or structural factors. In the Eurozone, however, we have a slightly lower long duration conviction, given the currently priced terminal rate of 2.5% is not very far from our estimate of 2.25%. Also, our fair value model suggests that the Bund is fairly priced at current yield levels of around 2.5%.

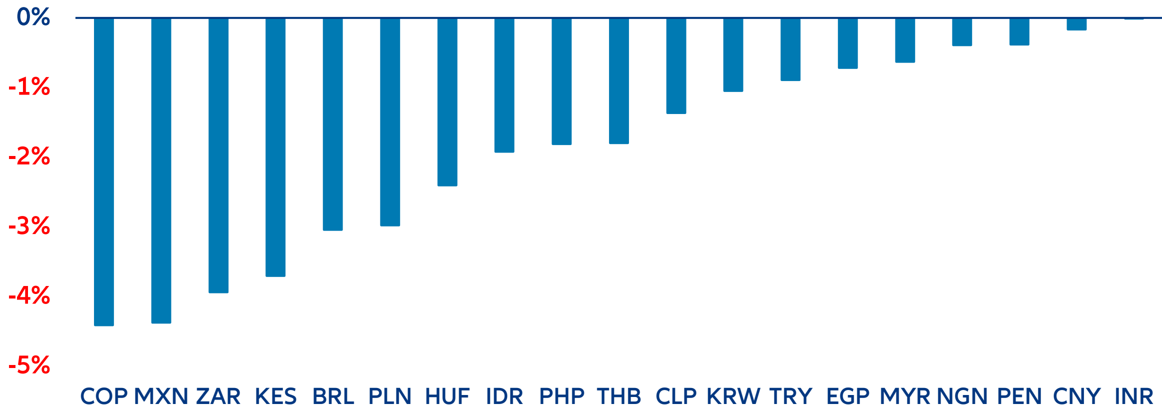
[5] *See our report Global economic outlook: It's a wrap!*

EM financial markets – fasten your seat belts

Risks of a delayed easing of US monetary policy are casting a shadow over emerging economies. With market expectations recalibrating towards potentially fewer Fed rate cuts this year, emerging markets (EMs) are feeling the pinch. While they managed to withstand the more gradual shift in expectations seen in Q1, the US March inflation report has created shockwaves in the form of capital outflows, currency depreciations and volatility of financial assets.

Exchange rate weaknesses are a wake-up call. The strengthening of the USD – which has gone beyond EM currencies to affect major ones like the EUR or JPY as well – is the reflection of changing investor sentiment, with USD-denominated assets increasingly in favor as interest rates rise. This flight-to-haven behavior – temporarily exacerbated by the growing tensions between Israel and Iran – is proof of the fragility of the current market environment. Some of the currencies that are investor favorites for carry trade in this cycle, such as the MXN and BRL, are among the hardest hit (Figure 4), though for now this is not a sign that markets are more worried about these countries than others. However, for countries that are struggling with other issues, such as growing political tensions due to upcoming elections, this situation can exacerbate outflows. The lack of immediate market reaction is not necessarily positive either: for countries intervening in markets to either maintain certain exchange rates or control depreciations, defending their positions has become more expensive in terms of FX reserves. The longer this situation lasts, the more complicated it will be to maintain these policies.

Figure 4: FX performance of selected EM currencies vs the USD since 9 April

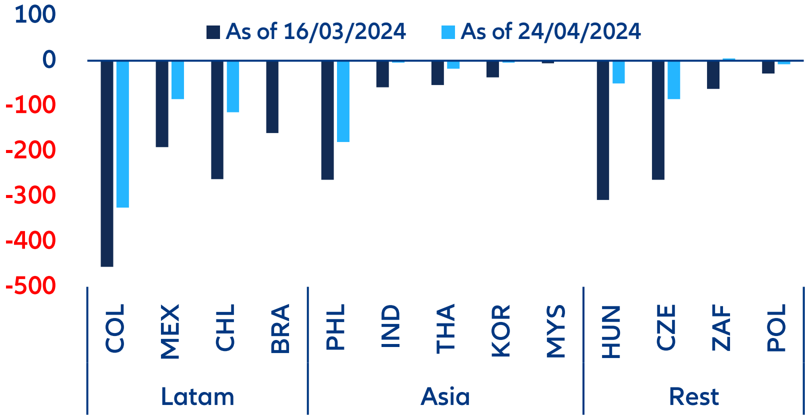


Sources: LSEG Datastream, Allianz Research

EM central banks are now caught between a rock and a hard place. Since late 2023, many EMs embarked on a path of monetary policy normalization, spurred by the promising direction of domestic disinflation, growing concerns over the economic and fiscal impacts of high interest rates and confidence in the anticipated easing cycle by major central banks. And markets' seamlessly reaction seemed to approve of EMs taking proactive steps without waiting for the Fed's lead[6]. But now the situation has changed. As markets have dialed back their expectations for cuts in advanced economies, they have also done the same for EMs; in some cases the adjustment has been larger than 100bps for the next 12 months (Figure 5). While needed to maintain financial stability, this development does not make it easy in economies that continue to require monetary easing to accelerate economic growth.

[6] *Or, for Eastern European countries, the ECB. Although in this case the magnitude of the 2022 inflation shock was larger in absolute and relative (compared to their average inflation in their recent history) terms.*

Figure 5: Comparison in market-implied policy rate cuts (bps) in the following 12 months: what was priced in mid-March vs. what is priced in end-April



Sources: Bloomberg, Allianz Research

EM bond yields have risen above our expected year-end values, but a cautious approach should prevail as downside risks are also on the rise. Not only were EMs very effective in countering the inflationary pressures and managing the tightening cycle[7], but this year they have also managed to issue a great part of the borrowing needs for 2024 when it comes to foreign exchange-denominated debt, taking advantage of the more favorable market conditions. As such, and even though higher-for-longer refinancing rates could put debt sustainability at risk, markets have maintained their pricing of risk premium stable for major EM sovereigns. The market consensus for now is that as long as the current repricing is "just" a delay of Fed cuts to 2025 and not of higher terminal rates, the impact on EM yields should be temporary as well. Nevertheless, the downside risks have increased compared to our March outlook, and they will continue to do so the longer uncertainty remains because it will translate, little by little, into higher effective costs of debt. As of now, yields of our benchmark hard currency sovereign bond index are at 6.7% vs. 6.2% at the beginning of the year, while spreads have even compressed (200bps vs. 215bps at the beginning of the year). Going forward, we expect a moderate spread widening for hard currency bonds to 225bps by year-end, while yields overall should decrease to 6.25%, thanks to the decrease in risk-free rates. Similarly, we also expect yields of local currency bonds to decrease until year-end (close to 6% for our benchmark), although the initial expectations of a relatively weaker USD in 2024 have faded.

Inflation and election results: There is no nexus

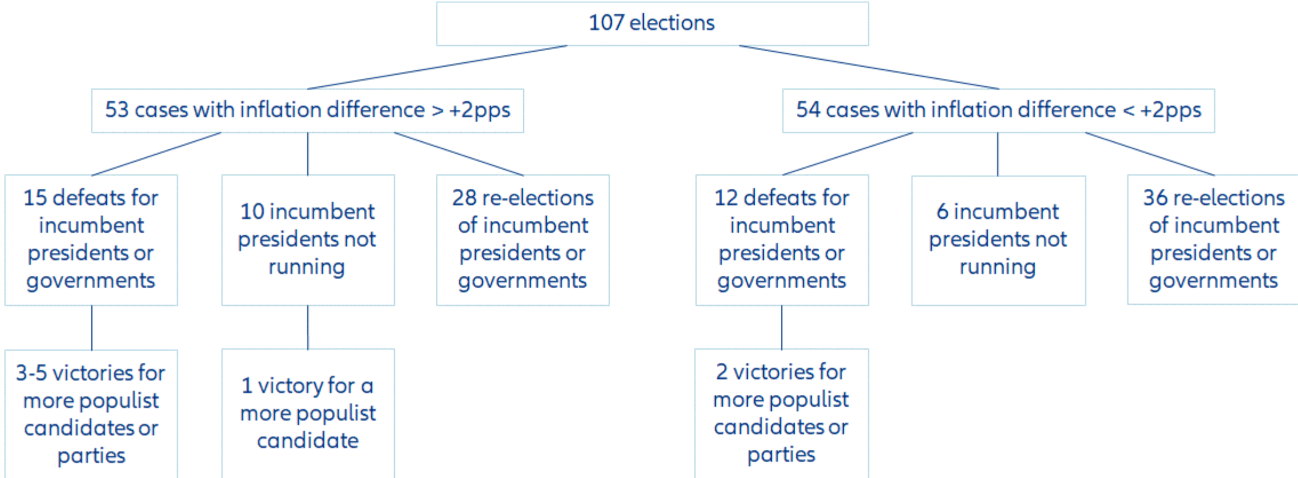
Did the return of inflation in 2021-2023 affect election outcomes? Recent research has raised the question of whether the negative effect of inflation on consumers' purchasing power played a role in recent election outcomes[8]. To find out, we look at 107 presidential and parliamentary elections in 63 major developed and emerging markets since 2021. We calculate the difference between the average year-on-year inflation rate in the last six months before the elections and the average annual inflation rate in the five full years before the election year. Assuming that such a difference is significantly felt by voters if larger than +2pps, we compared this with the election outcomes. As shown in Figure 6, the majority of incumbent presidents or governments were re-elected, regardless of whether the inflation trend before the election was significantly positive or not. At best, there was a moderate advantage for opposition candidates or parties to win if inflation was significantly higher shortly before the election. Moreover, in the 53 elections in which the latter was the case, a significantly more populist president or government was elected

[7] *Probably one of the best regions at doing that has been, with exceptions, Latin America. See Latin America: shall we dance? our latest report on the continent.*

[8] *See for example www.brookings: inflation-politics-is-clearer-than-inflation-economics, www.abcnews: inflation-helped-decide-elections-worldwide, www.ceyda oner (imf): Inflation-prices-on-the-rise, www.reuters: fed-report-cites-inflation-us-election-key-financial-stability-risks-2024-04-19, www.thefulcrum: the election may turn on inflation, but do we even understand it, www.businessinsider: 2024-elections-inflation.*

than before in six cases at best.[9] This compares with two shifts to more populist outcomes out of 54 elections which did not come along with increased inflation.

Figure 6: The inflation effect on elections (January 2021 to April 2024)



Sources: Various, Allianz Research

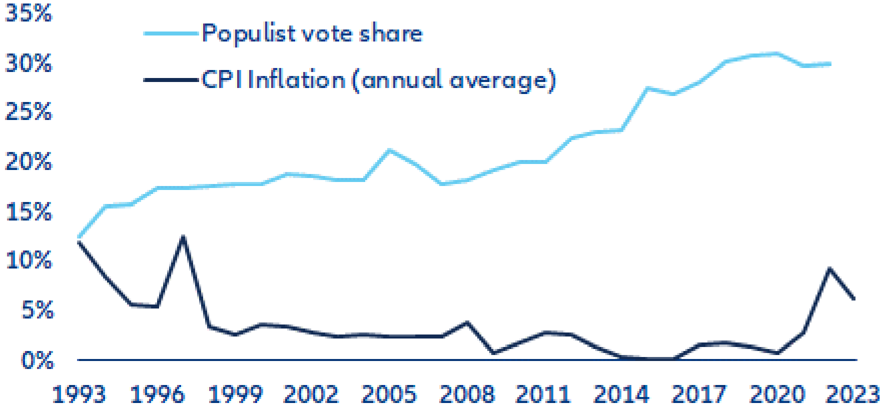
However, Argentina, Italy and the US are prominent exceptions, which, like Slovakia, Finland and Bulgaria, have switched to governments perceived as more populist against the background of increased inflation. Argentina's President Milei was elected in November 2023 with a populist agenda, while in Italy, a right-wing coalition led by the far-right Fratelli d'Italia won a comfortable parliamentary majority in September 2022, although some analysts argue that the previous "national unity government" under former prime minister Draghi also included several populist parties. In the US, the Republicans took over the majority in the House of Representatives from the Democrats in the mid-term elections in November 2022, which can be seen a shift towards more populism (particularly with regard to foreign trade restrictions and migration), which the Republicans have increasingly pursued since of Donald Trump's presidency (2017-2020). In Slovakia, the populist left-wing nationalist Smer-SD party led by four-time Prime Minister Fico, who frequently uses pro-Russian rhetoric, has been leading a coalition government after the September 2023 legislative elections. In Finland and Bulgaria, parties labelled as populist (Finns Party and GERB, respectively) also became part of coalition governments in recent elections.

It should also be mentioned that in a number of countries, incumbent governments were re-elected despite double-digit inflation at the time of the last elections. These include populist or hardline presidents in Türkiye (2023), Egypt (2023) and Serbia (2022) as well as parties or coalitions with a parliamentary majority in Argentina (2023), Türkiye (2023), Latvia (2022), Estonia (2023), Serbia (2022) and Brazil (2022). Moreover, in Poland, the centrist Civic Coalition under Prime Minister Donald Tusk overtook the populist PiS party in the 2023 parliamentary elections.

There is also no long-term positive correlation between inflation and the populist vote share in the EU. The share of populist votes in total votes in the EU has increased steadily over the last 30 years, from 12% in 1993 to 30% in 2022. At the same time, average annual inflation in the EU has fallen from an elevated level in the early 1990s to a moderate level of below 4% in the period from 1998 to 2021, before rising temporarily in 2022-2023 as a result of the sudden sharp rise in energy prices following the outbreak of war in Ukraine (Figure 7). The long-term correlation between the two indicators is clearly negative (-44%).

[9] *The terms "populist" and "more populist" are of course subject to subjective perceptions. For European countries, we have oriented ourselves on the categorization of parties by [The PopuList: A Database of Populist, Far-Left, and Far-Right Parties Using Expert-Informed Qualitative Comparative Classification (EiQCC) | British Journal of Political Science | Cambridge Core]), September 2023. For non-European countries we have followed the categorization in the majority of press articles.*

Figure 7: Average annual inflation and populist vote share in the EU



Sources: IMF, The PopuList, Allianz Research

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