Here’s why market rates should head higher still

We find the notion of medium-term upward pressure on rates convincing. It's not all a macro inflation story, even if that is a good one. It's also a new drive to central bank sentiment (BoE etc), and a Fed that will eventually get a bank reserves reduction plan going. That three-way combo can push rates up, debt ceiling complications apart

The United States Capitol Building, home of the USA Congress on National Mall in Washington, D.C.

Source: Shutterstock

Sticky inflation and a healthy dose of hawkishness

Market rates have been on the rise for two months now, having bottomed at the end of July. Not a whole lot has really changed to really rationalise the move, but we can point to some ongoing drivers, ones that culminate in a likely push higher in market rates.

On the macro side, the stickiness of inflation has become more evident, even if complicated by supply constraints, which themselves are proving less temporary than many had expected. Fixed income markets hate inflation, or are supposed to, and in any case will find it hard to ignore if it just does not go away quickly enough.

The belly (5yr area) of core curves have come under cheapening pressure

On a technical front, the belly (5yr area) of core curves has come under cheapening pressure, with market rates there rising the most. This is an anticipatory move, where the curve begins to make some room for future rate hikes, but not imminent ones. The best example of this is on the US curve.

Euro and UK rates are on the up, too

The eurozone curve is feeling the same pressures, but being less steep than the US in not pricing in material rate hikes until well after US moves. The sequencing here sees the Fed hiking from 2022 onwards while for the eurozone, rates hikes are closer to a 2024 event (and lots can happen between now and then).

The UK curve is a step ahead of this again, where the pressure has elevated on the front end through a ratchet higher in 2yr market rates, in anticipation of even sooner rate hikes. It’s unusual for the UK to move ahead of the US, but the market discount is paying close attention to the notion that an earlier UK rate hike is a live risk.

Central banks need higher market rates too

One of the issues with all of this is the 10yr (and 5yr) market rates ideally need to be higher than they currently are, so that central banks have the room to manoeuvre official rates higher in the coming years, ideally without threatening to invert yield curves.

Central banks need higher market rates to create room for future hikes

Remember, this future phase of rate hikes is engineered to take the foot off the accelerator and take them to more neutral levels, and not to slam on the brakes. Forcing curves into inversion would not be fitting with this. In consequence, policymakers would likely prefer for market rates to be more anticipatory.

And ahead, the Fed will take reserves from the system

The US 10yr heading towards 2% is a fitting objective, and would act as a beacon for other core markets to follow. Even if macro factors don’t push us there, a key technical pull will come from the period after the Fed has completed tapering, as there will be a subsequent requirement to take bank reserves out of the system. This, in fact, would feel like a Fed bond selling programme (QE reversal) even if it's not, which should ultimately result in upward pressure on market rates.

The debt ceiling is preventing the Treasury from mopping up liquidity through bills issuance, and this could become quite perverse.

For now, the Fed is taking in short-term excess liquidity. The debt ceiling is preventing the Treasury from mopping up liquidity through bills issuance, and this could become quite perverse. The likely short-term raise of the debt ceiling helps avoid potentially huge complications. Raising it can also ease the excess liquidity circumstances that show up in the Fed's reverse repo facility. And that, followed by a taper, and an eventual reduction in bank reserves should correlate with some upward pressure on rates.

That said, the mooted temporary short-term solution to the debt ceiling keeps the whole complication simmering in the background as a frustrating technical issue that mutes upward pressure on market rates.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com