Here's why rates will keep on rising

Market rates are set to rise as financial conditions are not tight enough in the US; the US 10yr yield could even go as far as topping 3.5% again. That will pull rates higher elsewhere, including those in the eurozone. Remarkably, financial conditions are significantly tighter in the eurozone than in the US. That heaps more pressure on the Fed than on the ECB

Remarkably, financial conditions are significantly looser in the US than in the eurozone

So, how do central banks fight inflation exactly?

Central banks impact the macroeconomy by finessing financial conditions. It's not as simple as setting official rates though; it requires the wider financial system to push in the same direction. Most importantly, market rates need to be in tune with central bank thinking. Credit spreads are key too; wider credit spreads add to the all-in funding costs for corporates and households, amplifying the impact of higher market rates. And this together with other central bank liquidity management tools will broadly determine overall financial conditions.

Not sure I'd recognise a financial condition if I saw one …

- **What can central banks NOT do?**
  - Impact the supply of energy, raw materials, labour and housing (important stuff)
- **What can central banks actually do then?**
  - Impact financial conditions. That's it! (extremely blunt and roundabout means)
- **What helps to tighten financial conditions?**
  - Higher cost of credit & FX, lower risk asset valuations and less availability of credit
- **How does that help?**
  - Tighter financial conditions help to dampen macro demand, thus taming inflation

Source: ING estimates

Eurozone financial conditions are already looking quite scary

In the eurozone, the Bloomberg measure of financial conditions has seen a virtual collapse from June through to August. At the beginning of June, conditions were moderately tight (about 0.25 of a standard deviation below normal). By the end of August, they were extremely tight (some 2.5 standard deviations below normal). This contrasts with extremely loose conditions at the beginning of 2022 (1.5 standard deviations above normal). The ECB of course hiked in mid-July, preceded by an end to bond buying (and targeted longer-term refinancing operation unwinds), which tightened eurozone financial conditions.

Remarkably, lower market rates and tighter credit spreads through July did not prevent an overall tightening in eurozone financial market conditions. In fact, they're looking quite scary right now. They are practically back to the extreme briefly seen when the pandemic first struck, and the only periods where eurozone financial conditions were tighter were during the Great Financial Crisis of 2008 and the Sovereign Debt Crisis of 2011. This suggests that the ECB has less to do. All they need to do is sustain this, not intensify it. Super big hikes are not needed.

Remarkably, US financial conditions are still too loose

There is a remarkable contrast to be drawn with the US, where financial conditions tightened right through to the end of June (1.5 standard deviations below normal), driven by Fed hikes, rising market rates and wider credit spreads. But then it reversed. A notable fall in market rates and a tightening in credit spreads, which ran from mid-June to end-July, loosened US financial conditions quite considerably, pulling them practically back to almost normal by mid-August. Remember the US 10yr yield fell from 3.5% to almost 2.5% during this period, and risk assets rallied. Hence the easing in conditions.

This easing was counter-productive to the Fed's stated ambition to tighten financial conditions, and was a factor underpinning the crystal clear speech from Chair Powell at Jackson Hole: this Fed wants and needs to see tighter financial conditions, and will do its bit to tighten them by hiking the funds' rate at upcoming Federal Open Market Committee meetings. In fact, in the lead-up, and through the second half of August, market rates and credit spreads reverted and started to do what they should be doing at this stage of the cycle, rising and widening respectively.

A stark contrast

Currently, we find a stark contrast between the eurozone and the US. US financial conditions are just 0.35 of a standard deviation below normal, while eurozone ones are 2.5 standard deviations below normal; even though it's the Fed that's done most of the tightening. From the perspective of the US, a required objective is to re-tighten conditions considerably from here, which is code for rising bond yields and widening in credit spreads, to be capped off with a 75 basis point hike from the Fed on 21 September.

For the eurozone, things are more opaque. There is a deeper energy-impacted macro crisis afoot, and financial conditions are already super tight. Higher market rates and wider credit spreads ahead can deepen this further. The ECB can cap this off with a decent hike in September but does not need to do as much cajoling as the Fed might have to do in the weeks ahead. And the ECB does not need to do as much aggregate hiking either, relative to the job the Fed still has to do.

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