Rates Outlook: The liquidity overflow recedes

The year ahead will feel quite different to the year just gone. The warm cloak of liquidity will feel that bit less secure as conditions begin to tighten up. Overt US rate hikes will add to that, as will talk of ECB ones to come. Market rates should be running ahead of this, pulled there by inflation. But fixed income demand and lower net supply will mute rate rises

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1 The price of liquidity should rise as it becomes less abundant

One of the key themes for 2022 and into 2023 centres on the reversal of the various avalanches of central bank liquidity that have dominated in the past number of years. For the US, the re-injection of liquidity, mostly through bond buying by the Federal Reserve, was pandemic related. For the eurozone, it's been an ongoing process right back to the years following the great financial crisis, one that morphed into a sovereign debt crisis. Masking problems with liquidity has been a popular policy response. It's quite an opaque tool, but one that has likely kept the eurozone intact, and more recently has helped to facilitate an impressive recovery in the US. And the latter has been crucial for recoveries elsewhere.

Things are different as we head into 2022. Central banks are eyeing an end to bond buying programmes. The Bank of England is on the verge of ending its programme, following on from the Bank of Canada. Federal Reserve Chair Jerome Powell is now talking of an accelerated taper, and in all probability the European Central Bank will have ground its bond buying programme to a halt by the end of 2022. Even if we stop there, these are huge developments. But there is a reasonable possibility that some central banks take the next step by allowing bonds to roll off the front end, and beyond that either repoing bonds back to the marketplace or go hard and sell bonds back to where they came from.

As the price of liquidity is effectively the interest rate, any reduction in excess liquidity should place upward pressure on market rates, especially where liquidity shrinks. The ECB will increasingly set the scene for an eventual unwind of the likes of the TLTRO. The Federal Reserve will begin to reduce bank reserves at the margin, which will make conditions feel that bit tighter. And the Bank of England may well take the biggest step and allow bonds to roll off the front end, thus securing purposeful shrinkage in its balance sheet. These will be quiet moves behind the scenes that will place upward pressure on market rates.

2 Elevated inflation and rate hikes pulls curves higher from both ends

The other key drivers of market rates are more straightforward - inflation and the need for central banks to react to it through interest rate hikes. The latter will, by definition, push up front end rates, certainly in the US and UK, as they hike in 2022. But the eurozone too should see some upward pressure on the front end as we gear up for a rate hike cycle that we expect to begin in early 2023.

The response of the marketplace to inflation is a tad more complex. It should not be, as inflation is an outright negative for fixed income. But we've seen in 2021 a remarkable resilience to some quite severe spikes in inflation in the US and the eurozone. Market rates are higher as a theme in 2021, but it's been quite a tough lift.

For 2022, as inflation remains an unresolved issue, upward pressure on market rates will continue to emanate from it. It may not be the dominating factor, but it is one that is not going away as easily as some had predicted. Ask Chair Powell.

3 Supply versus demand dynamics will dampen the rise of longer rates

At the same time, we can't forget that demand for fixed income has had a key dampening effect on the ambition for market rates to rise in 2021. This reflects the impact of overseas demand for US Treasuries, quite aggressive central bank buying and technical buyers like corporate fixed rate receivers, pension fund buyers as a natural hedge for liabilities and the required re-calibration of bond/equity proportions as equities rallied in 2021 (and 2020).

Many of these factors will remain in play for 2022. But many won't, like central bank buying, and the environment for risk assets is likely to get tougher.

The other wrinkle that we observe is lower net supply of government bonds for 2022. This will make supply pressure feel less heavy. In the US, we find that the reduction in net supply is comfortably in excess of the loss of Fed bond buying for example. This dampens supply as a driver for higher rates in 2022.

In fact, it should allow for some re-richening in government bonds versus swap curves. Especially in the US, where USD Libor persists, and is likely to come under rising pressure, reflecting tighter credit conditions generally. This occurs against a backdrop where US rates should continue to lead eurozone rates higher, widening spreads between the two.

> So there are lots of moving parts for 2022, and many of them are conflicting. In net terms, we see higher market rates as winning out. We target the US 10yr to hit 2% and the eurozone 10yr to get to 50bp, and keep rising. That effectively requires a repeat of the net rises in market rates seen in 2021. But expect some big, fast moves in 2022. The 10yr should make the big move in 1Q, and the 2yr at the latest by 2Q. That will set the scene for the subsequent delivery of rate hikes.

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