

Rates Spark: A decisive week ahead

Rates have adjusted higher over the course of the week, with the unabated rise in energy prices adding to the backdrop of central banks having turned more hawkish. Next week's US jobs data could cement a Fed taper announcement in November, and add to the markets feeling of a mistake in the making.



Awaiting the curve's verdict

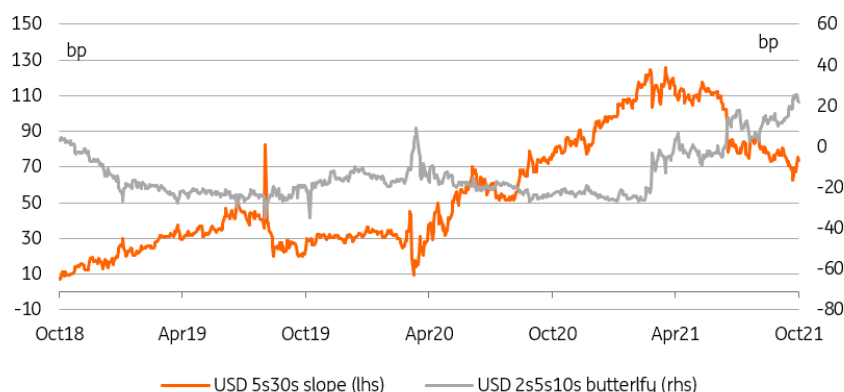
The upcoming week will be decisive for US markets and their pricing of the Fed's monetary policy. Next Friday will see the release of the September job market data. The consensus sees non-farm payrolls increasing by 500k, which should be enough to see the Fed announcing the tapering of its bond purchases in November. And on the back of a strong job number the market could move towards pricing an even more aggressive rate hike path starting around the middle of next year.

A strong job number the market could move towards pricing an even more aggressive rate hike path

Yesterday had the Fed's Bostic on the wires saying that a rates lift-off is forecast for next year and

three hikes in 2023 now that the Fed has met the standard of “substantial further progress” on its mandates. Currently the Jan22 to Jan23 Fed funds Futures spread of 27 basis points shows markets already fully braced for one full hike in 2022. Similar analysis of the OIS curve for 2023 shows an expectation of another two hikes and a partial third. But it is beyond 2023 that market pricing really starts to fall back behind the Fed's dot plot forecast.

US curve dynamics are in flux, can 5s30s re-steepen if 2s5s10s continues to cheapen?



Source: Refinitiv, ING

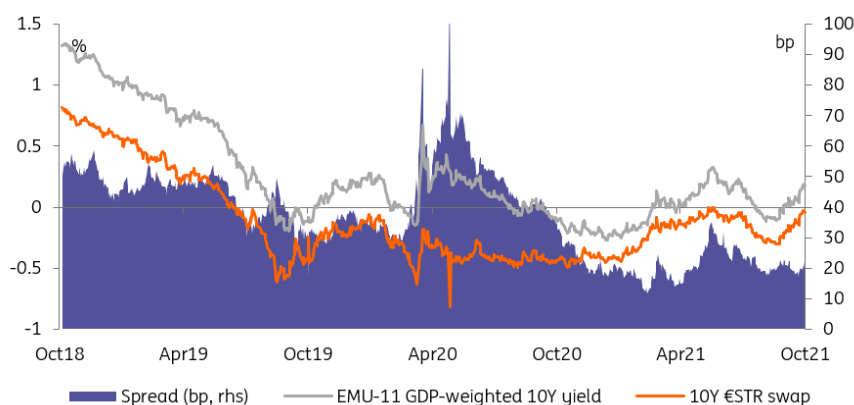
For us it will be interesting to observe how the US yield curve will react once remaining doubts about the impending Fed taper are being removed. Merely looking at the 5s30s and absolute levels of the 30Y rate suggests a further increase here would also leave room for the curve to steepen further. However, the read across from an already very cheap and further cheapening 5Y rate on the 2s5s10s butterfly suggests the curve could also take a turn towards a flattening again, implying that the Fed would move closer towards committing a policy error as supply chain disruptions and higher energy prices take their toll on the (global) recovery and long term growth outlook.

In the same vein risk assets continue to trade subdued, and it is difficult to see what could get them out of their rut. And that may eventually feed back into rates at some point to slow their increase. Overnight price action has seen the beginning of this dynamic at play.

For now the ECB ranks are holding

Stressing the transitory nature of current price pressures appears to run into some limitations also in the Eurozone. Money market pricing is at its most aggressive since before the pandemic. Keep in mind that since then the ECB has switched to a new strategy regarding its inflation target. As stretched as they may seem to us, to an extent these levels are spill-over effects from the US and the UK, and further rises in sympathy seem possible.

EGBs spreads are oblivious to any ECB hawkish risk



Source: Refinitiv, ING

But in light of eye-watering inflation readings of the likes we will get today, and even higher ones in the next months, it may only be a matter of time before some of the more hawkish voices of the ECB make themselves heard again. Their easiest target would be the nature of bond purchases post the pandemic emergency programme - PEPP. So far they have been eerily quiet, but Eurozone periphery bond spreads over Bunds are starting to feel some pressure as the uneasiness spreads.

the picture for EUR rates is turning less constructive next week

Post month-end the usually rates supportive factor of index extension flows will fade. The pressure from the supply side should remain moderate for now in the vicinity of around €20bn next week, though with France (which will announce its auctions today) we will likely get some longer duration supply. The week thereafter then sees the EU lined up for a syndicated deal. In short, the picture for EUR rates is turning less constructive next week, likely exposing even more to the dynamics abroad.

Today's events and market view

The data calendar leaves the focus on rising price pressures. Having passed month-end, markets may have more room to follow to the bearish drumbeat, despite all ECB assurances that high inflation should be transitory. The Eurozone will get the inflation estimates for September. The current consensus is for an increase to 3.3% year-on-year in the headline and 1.9% in the core reading. German CPI already jumped above 4% yesterday, even a tad higher than anticipated, while French CPI came in at 2.8%, not quite as high as expected. In other data we will get the first manufacturing PMI readings for Italy and Spain.

In the US the core PCE deflator and data on personal income, spending are the highlights. While incomes should still rise amid employment gains and rising wages, inflation should also remain elevated. We will also get the ISM manufacturing report, which should show a slight moderation amid supply chain disruptions.

Authors

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

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