

## Rates Spark: A not so gentle reminder

The UK CPI print was the not so gentle reminder that central banks' mission is far from accomplished. Near-term direction for rates should still be up. Illiquid markets may have amplified the reaction along with its spillover into other markets. The UK curve especially can invert further, while the FOMC minutes counteracted the US flattening dynamic.



### The UK CPI triggered a significant bear flattening

The UK inflation print of 10.1% for July came as a stark reminder that central banks' fight against inflation is far from over. Front-end rates repriced dramatically with the Bank of England seen hiking another 150bp this year and 50bp in 2023, meaning the Sterling Overnight Index Average would top out at close to 3.70% in the first half of 2023.

For the broader curve this resulted in a further flattening and further inversion of the 2Y10Y down to -20bp in the trough before some of the initial move was pared.

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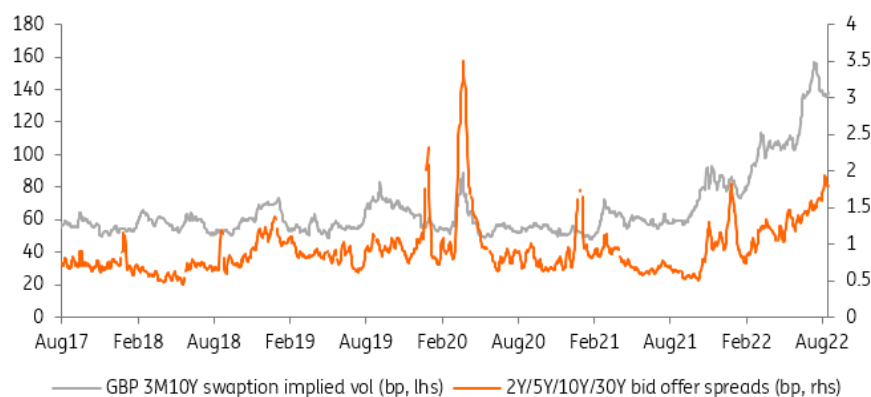
*With peak inflation still to come and recession fears on the rise  
the curve still flatten more*

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While [core inflation may be close to peaking our economists expect the headline rate to hover around 12% from October](#). At its last meeting the BoE hiked by 50bp while forecasting a long recession, and it suggested it could hike more depending on the next government's fiscal plans. With the peak in inflation still to come and recession fears further on the rise the curve has room to flatten more.

Of course market reaction may have been amplified by still illiquid market conditions. As far as Gilts are concerned, bid offer spreads remained on a widening trend and also implied volatility has proven stubbornly high. This is the market in which the BoE now intends to embark on active quantitative tightening soon – i.e. actively sell Gilts from its holdings. It will test market functioning as private investors will effectively have to absorb significantly higher amounts of government debt going forward. It is a factor that muddies our call for a flatter curve.

## Liquidity conditions in the gilt market make outright central bank sales risky



Source: Refinitiv, ING

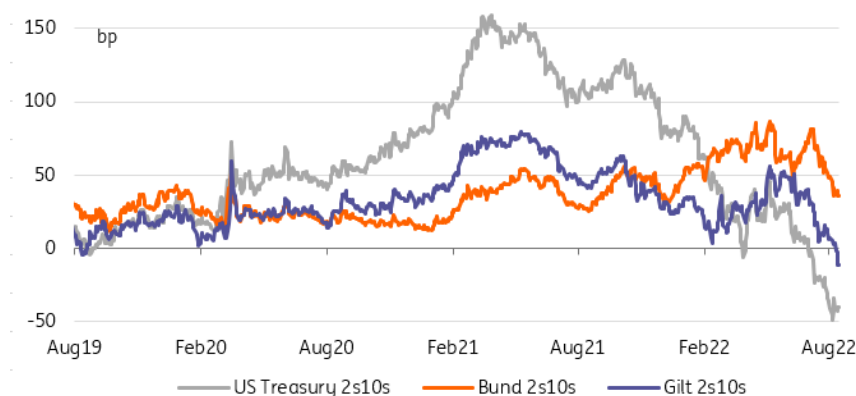
## EUR rates push higher from the front end...

Undoubtedly the UK CPI print has shed a harsh light on the issue that all developed markets are facing currently. Yet general market illiquidity may also explain strong reaction seen outside the UK.

The EUR front end saw sharp repricing higher with 1y1y ESTR OIS climbing more than 20bp as well. That is paired with rising recession fears, not just as the European Central Bank pulls in the reins, but also as other factors hit, such as a record drought crippling one of Germany's most important transportation lines – recession now looks inevitable. While the 10Y Bund yield still climbed some 10bp towards 1.1%, by the end of the day the 2Y10Y Bund curve was 5bp flatter.

Prospects of ECB tightening and higher core rates also put pressure on spreads, where the key 10Y Italy/Bund spread widened by 7bp to over 220bp. With the general elections in Italy only a bit more than a month away, that closely watched risk gauge will continue to see upward pressure – and keep the ECB busy using its first line of defence, the pandemic emergency purchase programme reinvestments.

## UK CPI pushed curves flatter beyond the UK's borders



Source: Refinitiv, ING

## ... but US flattening is counteracted by unexpectedly dovish FOMC minutes

US rates also saw a spillover from the UK figures which took the 10Y UST yield back to 2.9%. Yet the flattening of the curve was subsequently counteracted by the [release of the Federal Open Market Committee minutes](#), which at the headline also signalled fears amid the committee that policy could eventually be tightened too far into restrictive territory. From a market perspective three things stand out in the minutes:

1. The Fed thinks that real rates are still too low, even as they deem the nominal fed funds rate as being now at a neutral level. Ammunition there for expectations for higher nominal market rates, even though the impact reaction has been to test lower for rates, and for the belly of the curve to richen.
2. The Fed seems to be all over the place when assessing where financial conditions are. They note they are much tighter now (which is true versus where they were at the end of 2021), but at the same time note a relative ease to get access to credit and decent demand for it (which is indicative of a loosening in conditions). Since the minutes, financial conditions have loosened further; not ideal for a Fed that wants to tighten.
3. The Fed seems happy with the functioning of the reverse repo window, at which there is a 2.3% rate on offer. They also note that the doubling in the balance sheet roll-off volumes in the months ahead should ease the usage on the facility. We are certainly beginning to see this, as the usage seems to have plateaued, albeit from staggeringly high levels.

Overall, the market has seen yields fall a tad on the back of the minutes, but not in a dramatic fashion. Looking through this and focusing more on the Fed's need to in fact tighten conditions further, market rates should be forced higher despite the impact effect seen.

### Today's events and market view

In the wake of the UK data the final eurozone inflation figure for July released today should see special interest with some in the market seeing chances for a revision higher. Other data on the calendar comes from the US with initial jobless claims while remarks by the Fed's Neel Kashkari should also draw attention after last night's FOMC minutes with a

cautionary twist. Kashkari, especially, has cast himself as an inflation hawk in this cycle.

In eurozone government primary markets the sole supply comes from France, which sells shorter dated bonds and inflation linked securities for a still summerly amount up to €7bn.

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