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RATES SPARK

Rates Spark: A Wednesday afternoon of drama from the US

It's Fed day. There's lots going on and lots to mull over, but in the end not expected to amount to a whole lot. Still it's a big Wednesday. The Fed, of course. And the TIC data for April - see more on that [here](#)



Fed's dot plot will be watched, but uncertainty reduces its meaningfulness

No forecaster expects the Fed to change its policy stance on Wednesday and markets also price a steady hand as the FOMC is seen in a wait-and-see mode as it watches the outcome and impact of the US government's tariff policies. More focus will thus be on the Fed's updated projections and whether they will still show for instance the median expectation of two 25bp cuts this year. There is indeed a good chance that the median could shift to showing just one cut, as it would just take two FOMC members to change their view from two cuts to one.

The market is close to fully discounting two cuts this year with September as the likely date for the next cut. Another 50bp of cuts are discounted over the course of next year. Whether the market will react much and lastingly to such a shift in the Fed's so-called dot plot is doubtful. The current backdrop is just too uncertain and the Fed could quickly shift its view on changing circumstances and/or data.

Chair Powell should brace for some questions on the rate on excess reserves

A juicy element that Chair Powell may be questioned on is the recent suggestion from Senator Cruz that the Fed should not compensate banks for holding (excess) reserves. Traditionally minimum bank reserves were a regulatory requirement that paid zero interest. But, because of the large QE engineered during the GFC, banks had to be compensated at market rate levels for holding more reserves than they really needed. That coincided with a change in the way the funds rate was managed, with the rate charged on bank reserves operating as something of a soft ceiling (IOER at 4.4% currently). And loosely, the effective floor rate is proxied by the rate set on the reverse repo facility (RRP at 4.25% currently). Both represent liquidity pools, and both are avenues that the Fed employs to help manage liquidity circumstances. Moreover, they are two Fed levers that help guide the funds rate within the policy floor and ceiling rates (currently 4.25% to 4.5%).

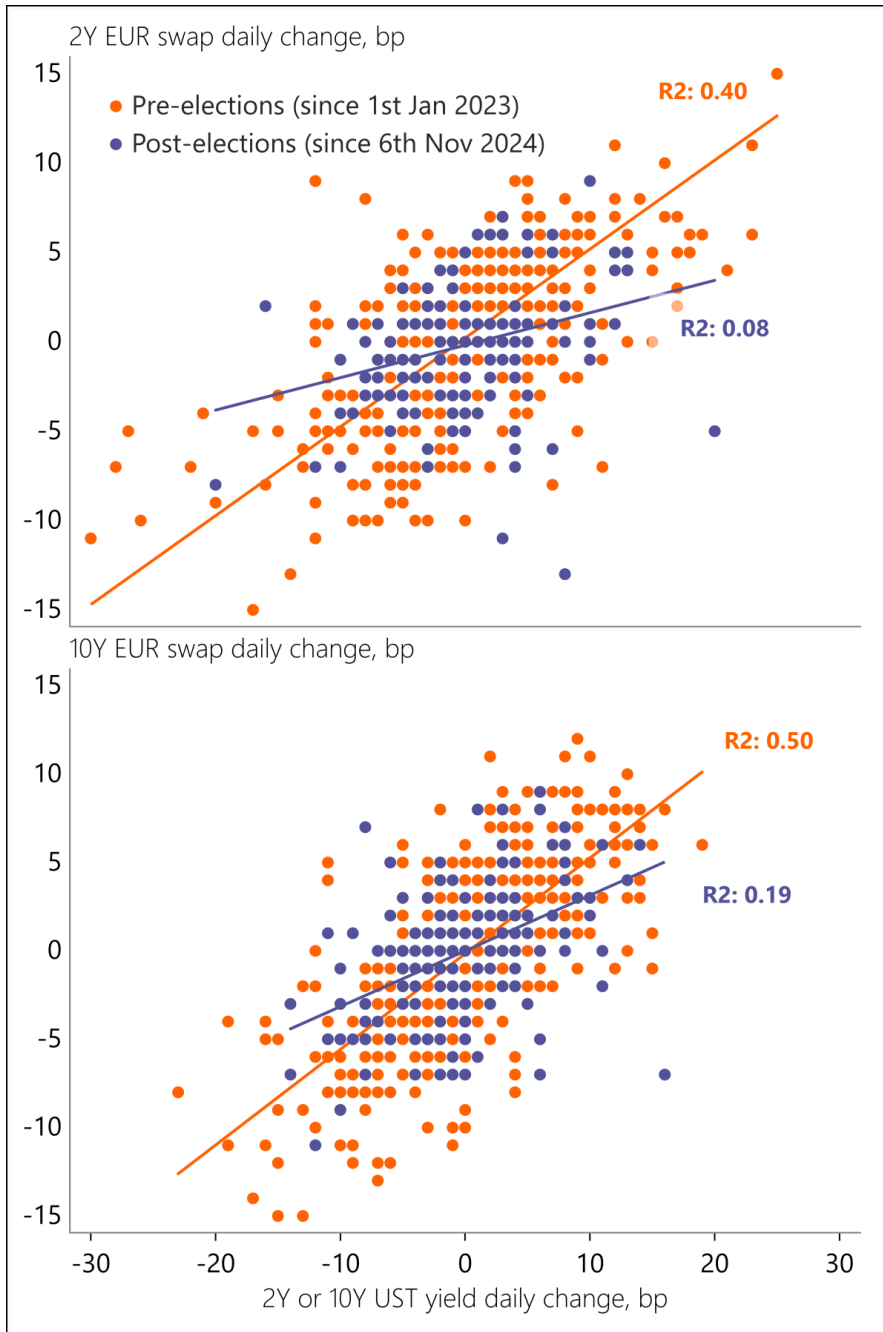
In our opinion, any decision that removes a rate compensation on bank reserves is certainly un-practicable, and potentially unworkable. Banks would then choose not to hold excess reserves, likely channeling liquidity excesses into reverse repo balances. But doing so would make the Fed's liquidity management job more difficult. Chair Powell won't bring this up voluntarily at the press conference, but it is likely a hot question that someone will ask.

Fed has little influence over euro rates since Trump's election

Whatever the Fed does, the spillovers to euro rates will most likely be limited. Since Trump's election, the correlation between the 2Y UST and euro swap rate has collapsed to practically zero. This suggests that going forward markets are seeing the European Central Bank moving independently from the Fed. Whilst before the US elections, markets saw the two move closely in tandem. For longer rates the rates are still correlated, albeit by a lesser extent. Longer tenors are simply more driven by global risk sentiment and less by the immediate outlook of central bank policy.

One reason for the disentanglement between euro and US rates is the tariff story. The consensus is that tariffs are predominantly inflationary in the US, whilst for the eurozone mostly deflationary. With tariff tensions being the key risks to both economies, the low correlation between the two markets is intuitive. If the current trade negotiations end in a relatively benign outcome for the eurozone, which we think has a high probability, then we could see the spread between 2Y US and euro rates tighten. But with 9 July as an important hurdle in the tariff talks, this may have to wait.

The short end of the euro curve is moving independent from the US



Source: Macrobond, ING estimates

Wednesday's events and market views

Ahead of the Fed meeting and after the release of UK CPI data at the open, European

markets will be mainly looking at a busy slate of ECB speakers for direction. The list includes Nagel, Villeroy, Panetta, Knot, Escriva and Centeno at an event in Milan, while separately Chief economist Lane participates at a conference in Amsterdam. The final CPI figures for May are the only notable data for the bloc.

Out of the US the market is not looking for a policy change from the Fed, but will be on the lookout for any hawkish surprise out of the updated projections. Ahead of the Fed the jobless claims data will be the main release after initial claims have gradually inched higher over the past weeks. The US will also publish the TIC data on Treasury holdings for the month of April.

In government bond primary markets we only have Germany reopening 20y and 30y bonds (€2.5bn).

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