Rates Spark: A week of central bank action ahead

Rates markets will closely follow central banks next week with Fed and BoE policy-setting meetings and the ECB allotting the penultimate targeted long term liquidity operation (TLTRO). US rates should stay in the driving seat, this time with hawkish risks lurking in the dot plot. UST-Bund has a good chance to move wider again.

Source: Shutterstock

Fed: hawkish risks lurk behind the dots

The Fed meeting next week has lost some of its ascribed significance already after the disappointing August jobs report. The lower-than-expected CPI reading this week was another win for those seeing price pressures as only transitory. While over the course of the past few months more Fed officials now think it is time to dial back stimulus and even Fed Chair Powell has said it could be appropriate to taper asset purchases this year, it is now widely seen as unlikely that the Fed will announce a taper already at the upcoming September meeting.

As opposed to looking for said announcement of a taper, this time around we see the hawkish risk lurking rather in the Fed's 'dot plot'. There is still data that could make Fed members twitchy - record job openings, the NFIB small businesses survey or just yesterday's surprisingly resilient retail sales figure, just to name a few. And today we will get the University of Michigan sentiment index measure of longer-run inflation expectations. If these were to notch higher, say somewhat above 3%, it could be the final nudge leading one or two more FOMC members to bring forward their first rate hike call to 2022 from 2023, within the Fed's 'dot plot' forecast.

The upcoming meeting should be enough to keep US rates in the driving seat for now. As we have outlined earlier this week we think rates more likely to drift higher. The break below 1.30% on the back of the CPI has been brief. Supply, in the form of a 20Y Treasury auction could be another drag on the market.

BoE: confirmation of a more hawkish tone

Gilts underperformed again yesterday, a dynamic amplified by Wednesday's higher inflation figure. But the BoE strategy has been well communicated and the Bank is already well into the tapering of its asset purchase programme, a feat which it plans to complete by the end of the year.

This does not necessitate a change of tack from the BoE today, at most a hawkish confirmation may be in order after the inflation print. But by itself we think there is probably little the BoE can do to dispel the markets' lingering concerns that currently prevent them from endorsing a more aggressive and steeper hiking cycle. While having shifted somewhat higher the forward curve structure sees rates starting to level off after an initial two to three rate hikes. Taking the BoE's guidance at face value, this suggests that the market does not expect the bank to come anywhere close to active reduction of the balance sheet (aka selling off asset holdings).

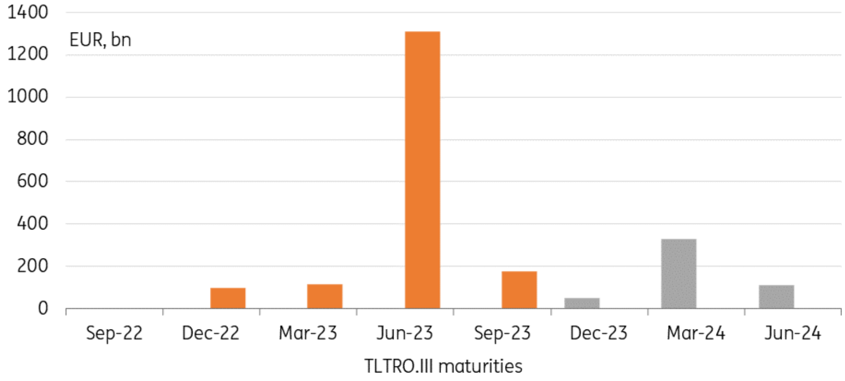
ECB: Tuned in to the dovish song

Markets have largely subscribed to the dovish script laid out by the ECB. This at least is what a 10Y BTP/Bund spread just below 100bp is telling us for instance. However, that makes markets potentially more prone to hawkish surprises and potentially bouts of higher yields on the back of data - we are eying the PMIs next week as potential flashpoints. After all the Eurozone has pulled through the current delta wave relatively well.

There is an operational aspect moving into view, as next week the ECB will allot the penultimate TLTRO.III tranche with one more following in December. Already today the ECB will disclose how much banks have chosen to repay out of the first five tranches where currently €1.7bn are outstanding. Our financials analysts expect to see little in terms of early repayments at this stage. More relevant will be what happens once the very attractive special interest rate period ends in mid-2022 and banks no longer enjoy a ultra-low borrowing rate of -1%. While Lagarde had touched upon the importance of the TLTROs in last week's ECB press conference, it is likely only closer to then that the ECB will also decide whether to extend the TLTRO.III operations.

For now the implication for money markets appear limited. They are currently swamped by more than €4.4tr of excess liquidity, which keeps front end spreads compressed and the overnight risk free rate pinned below the deposit facility rate.

Banks can now start to repay the first TLTRO.IIIs



Source: ECB, ING

Today's events and market view

With the US remaining in the driving seat as the Fed meeting draws closer, we also see chances for the UST-Bund spread to drifting wider again. That said hawkish risks on the side of the ECB and data might still lead to temporary tightening episodes.

For today the focus is on US data with the release of University of Michigan consumer sentiment index. Recall that the index had seen a significant dip on the back of delta variant and inflation concerns last month, the anticipation is now for a small rebound. Of particular interest will be the measure of expected price inflation, for 5-10Y ahead currently at 2.9%. A move over 3% could start to raise eyebrows at the Fed.

The eurozone sees the release of final inflation data for August.

Authors

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com