Rates Spark: August angst

Back in August, the Fed pushed back against an easing of financial conditions and triggered a sizeable sell-off in Treasuries. Markets will be wary of a repeat of this pushback in today's speech by Fed Chair Powell

The Treasury market is nervous about a repeat of the August hawkish Fed pushback

Market participants await nervously Powell's speech this evening after the October CPI report sent bond yields lower and riskier asset prices higher. Even if the surprise slowdown in inflation is good news, it is only the first in a long series of conditions the Fed needs to see before it pauses its hiking cycle. Longer-term, the direction of travel is indeed towards lower inflation and an end to this tightening cycle but we expect the Fed to take Fed Funds rates some 100bp higher than currently, just under 5%, before this is the case.

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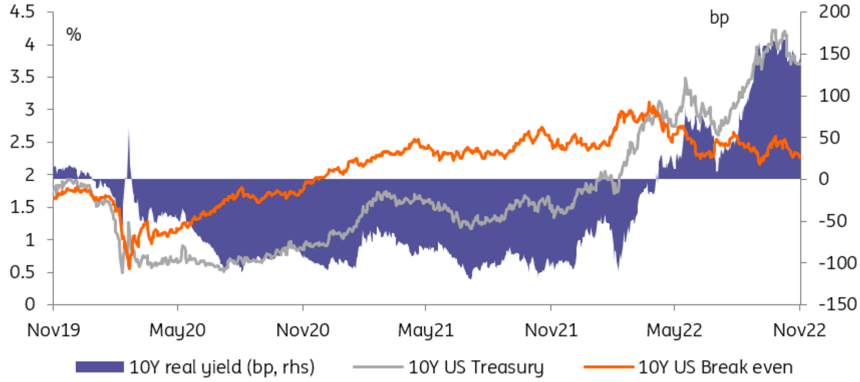
There is just over two months to go before the last hike in this cycle in our view. In the meantime, the Fed will be wary of markets undoing some of the painstakingly-delivered tightening of financial conditions. There is a precedent. In June to August of this year, 10Y Treasuries rallied 90bp peak to trough, helped by a lower-than- expected inflation report. This prompted a strong pushback from Fed officials in August, culminating in Powell's Jackson Hole speech. Treasuries went on to sell off 167bp.

The drop in nominal and real Treasury yields prompted a pushback by the Fed



Source: Refinitiv, ING

Closer to the end of this cycle but the 5Y is most at risk of cheapening today

Where this phase is different is that the Fed is having a harder time delivering its hawkish message as it signalled in no uncertain terms that the pace of hikes will soon reduce from 75bp to 50bp per meeting. There is still one employment and one inflation report before the December 14th meeting, but the burden of the proof is on those calling for another 75bp hike. Still, the 50bp drop in nominal 10Y Treasury yields, and 26bp in real yields, is a headache for the Fed. So is the aggressive flattening of the term structure, meaning that even if markets continue to expect the Fed to deliver hikes, the effect of these hikes do not feed through to longer borrowing costs. With Treasury yields over 100bp below where we expect the Fed funds rate to peak, we think the market is vulnerable to a sell-off around Powell's speech.

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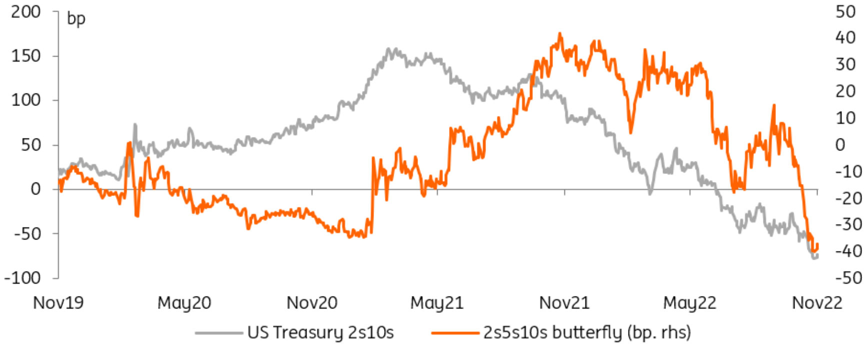
Curve flattening is an inevitable effect of markets seeing the end of the Fed's cycle, but we think this makes the sectors that rallied the most into today's speech most at risk of a retracement. Rather counter-intuitively, this should mean a re-steepening of the 2s10s slope on the Treasury curve. If Powell is successful in delivering his hawkish message, the 5Y point on the curve should retrace its recent outperformance, which will be visible in a richening of the 2s5s10s butterfly.

The curve flattening and richening of the 5Y point are at risk of retracing around Powell's speech



Source: Refinitiv, ING

Today's events and market views

The eurozone HICP inflation looms large on today's agenda. Spanish and German releases yesterday came on the low side of expectations, although this was less visible in the EU-harmonised measure that is most relevant for today's HICP print. Still, a confirmation that other member states are also seeing inflation ease off, however slightly, is welcome news for markets that looked overstretched after their November rally. German unemployment figures complete the list of European releases.

In bond supply, Germany will auction 10Y debt.

Fed Chair Jerome Powell is due to speak this evening. We expect him to push back against the tightening of financial conditions that occurred in the wake of the lower- than-expected CPI report.

US releases feature the second reading of US third quarter GDP, including core PCE. This will complete the ADP employment report, Chicago PMI, job openings, and pending home sales.

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