Rates Spark: Central banks keep rates on their upward trajectory

The hawkish central bank decisions have made it clear that the direction of travel for rates is higher. Disappointing US jobs data is something the Fed has signalled it is willing to look past, and so should markets. We examine the latest flows data which show the market is unprepared for the interest rate risk that was further amplified yesterday

US non-farm payrolls are the main event of the day, and we know that data will come in decidedly weaker owing to the impact of the Omicron Covid-19 wave

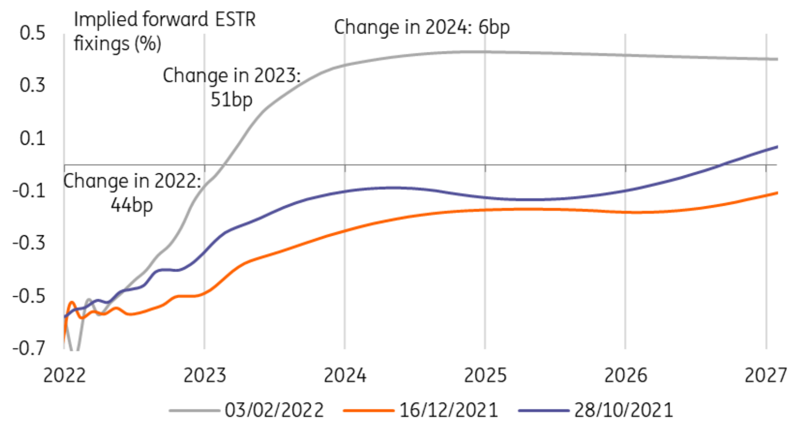
Everything is up in the air – inflation, front-end rates and, importantly, ECB guidance

> *The ECB itself does not exclude a rate hike this year*

The main takeaway from the European Central Bank press (ECB) conference is that the ECB itself now does not exclude the possibility of a rate hike this year. For net asset purchases, this implies that the current guidance, although it was repeated in yesterday's press statement, may change in March to show their end already earlier this year. This is what we infer from President Christine Lagarde stressing that the ECB will remain faithful to the sequencing of its policy normalisation.

It is only little consolation that everything the ECB does would happen "gradually" – a soft enough statement leaving leeway for markets to speculate about a first 10bp rate hike around mid-year. Our economists now see at least one hike before the end of the year, implying net asset purchases will stop after the third quarter. A source later confirmed that this was a possibility mulled also by council members.

Lagarde comforted expectations of higher ECB rates this year



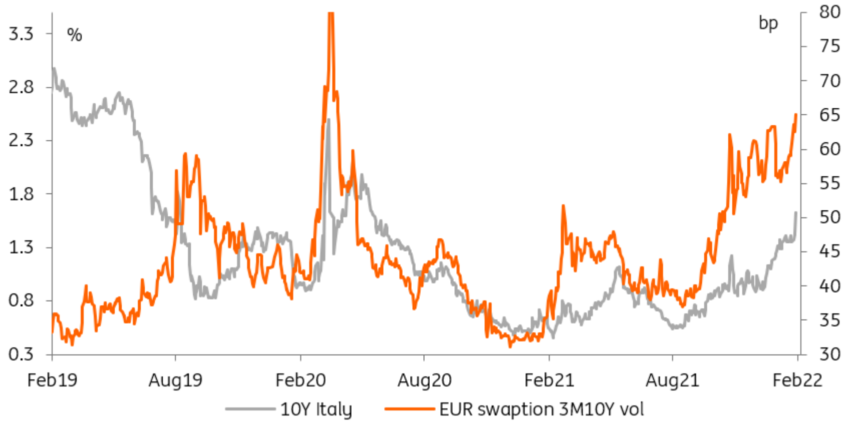
Source: Refinitiv, ING

Front-end rates soared after the press conference and money markets enter a no-holds-barred period, at least until more concrete guidance is offered at the next ECB meeting. Two hikes this year? Entirely feasible. By the end of the year, the market is now discounting 40bp higher overnight rates versus today's -0.58%. A terminal rate of 0.5% is what the market is now eyeing within two years. The 2Y swap rate, catapulted to 0.05%, has reached its highest level since 2H 2015.

Curve bear flattening can reflect fears that the ECB is quickly using up its policy space

The striking feature of yesterday's market reaction was the further flattening of the 5s30s curve towards a mere 13bp – recall early January we were at above 48bp! The bear flattening can reflect market fears that the ECB is very quickly using up its available policy space and risks choking off the economic recovery amid its inflation fight. Clearly though, investors are abandoning positions that looked for a more restrained ECB which would have allowed the curve to steepen as the economy gradually gained traction.

An abrupt end to ECB QE this year is the greatest risk to Italian bonds



Source: Refinitiv, ING

Another market segment that has not taken kindly to the ECB hawkish turnaround are sovereign spreads. 10Y Italian government bond spreads over Bunds, which had just seen a brief cheer after the re-election of Sergio President Mattarella, reached 150bp. One could argue that these are merely pre-Covid levels. We would go as far as to say Italian bonds got off lightly considering that asset purchases may well stop in the second half of the year.

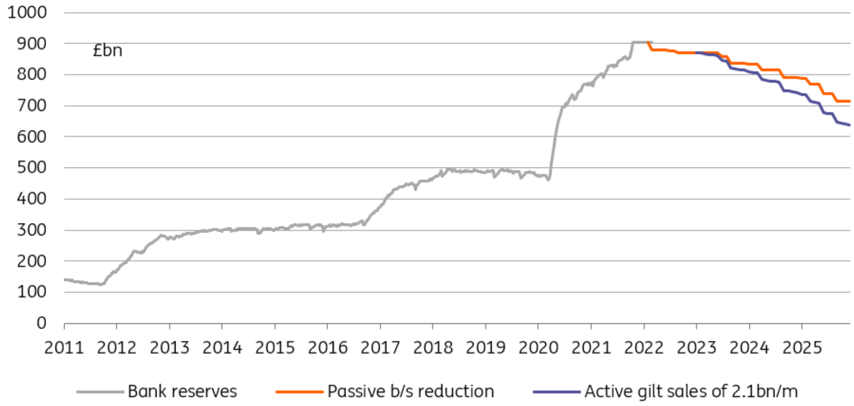
The BoE hikes as expected – and still surprises

The Bank of England (BoE) hiked by 25bp as widely expected, but it was the surprise that four out of nine votes were for an even larger 50bp hike that delivered markets the first hawkish surprise of the day. The Monetary Policy Committee vote signals more hikes are to come and our economist now expects the BoE to hike again in March and May.

The MPC vote signals more hikes are to come – likely in March and May

Reaching the 0.5% has now kick-started passive quantitative tightening (QT) – i.e. an end to reinvesting maturing government bonds – and raised the prospect of active sales before the middle of the year, should the Bank rate reach 1% by then. This is where we would expect the BoE to pause for thought on rates, not least to assess the impact of active quantitative tightening first. It is also where we start to disagree with market pricing that looks for five hikes in total this year.

BoE QT is starting in March, it could accelerate with active gilt sales



Source: Refinitiv, ING

There were hints of growing discomfort with aggressive market pricing in the BoE's new forecasts. Based on the latest market pricing, they show a larger output gap towards the end of its policy horizon, with unemployment ticking higher. And inflation is also forecast to be slightly below target.

Latest flows data point a picture ahead of the ECB amd BoE meetings yesterday

Flows data through to the close on Wednesday (just ahead of the ECB/BoE outcomes) show moderate inflows into government bonds, and a very slight re-build in duration, as the long end saw some returning inflows. This may in part explain the dramatic reaction on back ends, as they weren't expecting the additional interest rate risk that was delivered from the ECB and BoE. Interestingly, inflation funds saw their biggest outflows in more than two years, which should correlate with upward pressure on real yields.

> *Inflation funds saw their biggest outflows in over two years*

There was some duration reduction seen in investment-grade corporates, as long end selling dominated. While overall cash corporate outflows were mild, there were some more significant outflows from corporate high yield. Emerging markets saw the biggest outflows in blend funds (mix of hard and local currency), but overall outflows were muted by offsetting and ongoing inflows to local currency emerging markets. The concern for emerging markets now shifts to interest rate risk rather than foreign exchange risk as the US dollar has seen its bid dwindle post the ECB meeting.

Today's events and market view

We are tempted to look for rates taking a breather after yesterday's hawkish surprises, and that view may find support in a likely disappointing US jobs report today. But our main takeaway remains that the general direction of rates should be higher still.

The US non-farm payrolls are the main event of the day, and we know that data will come in decidedly weaker owing to the impact of the Omicron Covid-19 wave. The market's median expectation has come down to 134k with clear risks for even a negative number. Fed officials, however, have already signalled that a one-off bad jobs report, which is easy to explain, would not set them off course. Eventually, markets will likely look through this report as well.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com