

Rates Spark: It's not all about the Fed today

A lot of data releases and looming central bank meetings mean markets will remain choppy without much direction. These releases will shape the way markets react to central banks' tone, starting with the Fed tonight. We suspect investors are biased towards buying dollar bonds on dips



The Fed could over and/or under-hike other rates for technical reasons, but likely won't

Apart from the headline funds rate range of 4.25% to 4.50%, which will be adjusted higher by 25bp today, the Fed will also adjust higher the rate on the reverse repo facility and on excess reserves. These are currently at 4.3% and 4.4% respectively, and are often seen as the tighter corridor within which the effective Fed funds rate sits (currently 4.33%).

There is constant speculation on the likelihood for the Fed deciding to under-hike the rate on the reverse repo facility

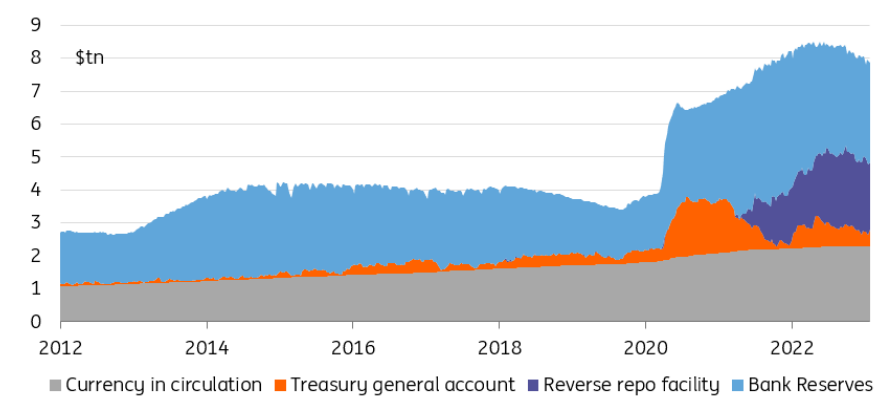
There is constant speculation on the likelihood of the Fed deciding to under-hike the rate on the reverse repo facility to bring it to flat to the Fed funds floor (it's currently 5bp over). The logic would be to encourage less use of this facility, which routinely takes in US\$2trn in excess liquidity on a rolling daily basis. However, in all probability, repo would simply trade down to the same area, without a material effect volumes.

There is a similar argument to instead over-hike the rate on excess reserves, say by 30bp (instead of 25bp). The idea here would be to encourage a downsize in the use of the reverse repo facility in place of an upside in bank reserves (higher relative remuneration). This would allow the Fed to better manage bank reserves, ensuring that they don't fall too fast, as they gradually ratchet their balance sheet lower through the ongoing soft quantitative tightening programme (as they allow US\$95bn of bonds per month to roll off the front end).

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In all probability, they won't do this either. There is already a 10bp spread between the reverse repo window and the excess reserves, and widening that to 15bp might not make a material difference. That said, a spread of 20bp just might, and is something the Fed could consider down the line, ie, under-hiking the reverse repo rate and over-hiking the rate on excess reserves. On this occasion, there would be quite a surprise if they did anything along these lines, at least not at this juncture.

Widening the RRF-IOER spread would slow the fall in bank reserves



The Fed could also upsize the quantitative tightening agenda, but likely won't either

The Fed has also been quite silent on the balance sheet roll-off programme. It seems that's the way they like it – churning away quietly in the background, and not causing too many market ripples. The big question in this space is whether the Fed could consider outright selling of some

bonds off its books, and to thereby engage in a harder version of quantitative tightening. It would be huge if they did. There is certainly appetite for bonds in the market, if the recent Treasury auctions are anything to go by.

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However, such selling of bonds outright would likely be a step too far at this juncture, as it would likely generate a tantrum. But it's always there should the Fed start to feel the fall in longer-dated market rates is acting contrary to their hiking efforts on the front end. Even a mention that they are looking at this down the line would have a material effect. Not expected, but these are potential market movers that we need to cross off as the meeting outcome unfolds.

Importantly, any mention of potentially upsizing the bond roll-off in the future or considering any bond selling (eg, of the longer-dated mortgage portfolio) would signal they were uncomfortable with where longer-dated market rates are at.

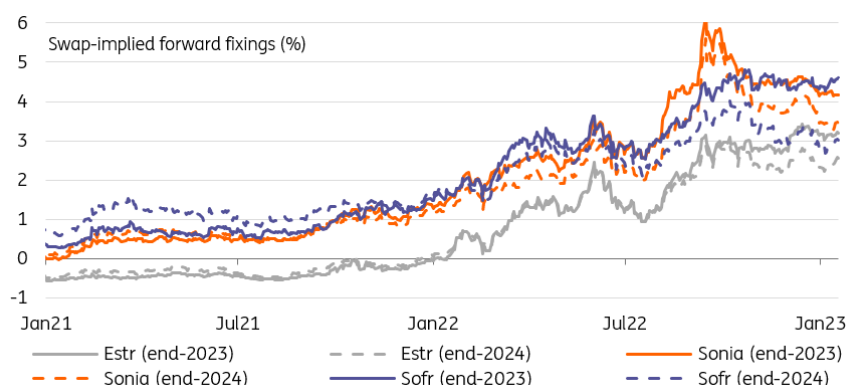
Today's data will frame how markets react to central bank policy

We started the week by saying that investors are increasingly relying on their own analysis of economic data, rather than on central bank guidance, to form their opinion about the direction of monetary policy. This is still true. Even in the run-up to [tonight's Federal Open Market Committee \(FOMC\)](#), and [tomorrow's European Central Bank](#), meetings, data should play a greater role in shaping policy expectations, and the direction of interest rates.

Central banks are purposefully behind the curve

One of the reasons is that central banks are purposefully behind the curve. Their past mistake in anticipating the inflation surge means they're unlikely to acknowledge it is going back to target until they have a much higher degree of confidence than now. The other reason is that markets are correctly priced for the next few meetings. We anticipate 50bp more hikes from the Fed, the curve is pricing 58bp, and 125bp from the ECB, where the market is pricing 150bp.

Swap curves are pricing rate cuts in 2024. The ECB should be more successful in pushing back than the Fed



Source: Refinitiv, ING

More labour data from the US, and inflation numbers from Europe

Where the debate gets more interesting, from the point of view of rates markets, is when one forecasts what will happen next. For the Fed, today's employment indicators (job openings and ADP) will determine how much credence the market gives its 'higher for longer' stance. So far, Fed communication isn't a success: the curve is pricing almost 200bp of cuts by end-2024. This is despite one having to look very closely at data to see the cracks forming in the labour market. Any change in this state of play could have the curve price even more cuts.

Fed communication isn't a success: the curve is pricing almost 200bp of cuts by end-2024

As things stand, we expect the ECB to be more successful than the Fed in pushing back against rate cut expectations, but they may well be given an assist by today's eurozone inflation print. This month's release is proving even more difficult than usual to forecast due to the annual re-weighting of components, and due to Germany delaying its own release until later in February. Spain's inflation surprised to the upside, France's didn't, so markets are none the wiser about today's release.

These releases point to choppy trading without much direction into the key central bank meetings, but they may well shape the way markets react to their tone. Our hunch so far is that investors would be minded to fade any jump in rates on a hawkish FOMC, while a hawkish ECB would be more credible and push euro rates higher, especially at the 5Y point.

Today's events and market view

The run-up to tonight's FOMC meeting will not be a boring one, for those into economic numbers at least. The main release is eurozone and Italian CPI, with the added uncertainty that the German component will be a temporary estimate. As usual, core inflation will be

the most important data point for markets trying to anticipate the ECB's next move. The consensus is for the core rate to slow down from 5.2% to 5.1% on an annualised basis but we suspect market expectations are skewed higher.

Other European data publications, manufacturing PMIs, will be less market-moving, barring significant revisions from the flash prints.

The deluge of economic releases will be interrupted by a 10Y debt sale from Germany.

US releases will feature PMI and ISM manufacturing. A fall in the ISMs below 50 last month was instrumental in shifting investor expectations towards our call for a US recession this year, and for rate cuts. If this wasn't enough, there will also be the ADP employment report, and JOLTS job opening to look out for, all instrumental in assessing when the labour market will allow the Fed to contemplate rate cuts.

This busy day will culminate in the evening with the FOMC meeting and Chair Jerome Powell's press conference.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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