Rates Spark: Early to the party

It's Fed day. We expect a 75bp hike to be delivered, and the ongoing rate hike story will be trotted out to counter too much pivot talk. Markets have already celebrated the Fed pivot party, leaving the bar to a dovish surprise too high for our liking. Front-end rates have been reluctant to join in, whilst Bank of England gilt sales are off to a strong start

This is one where the Fed does not to say too much at all and lets the market stew a bit more

The market discount for the terminal fed funds rate is very important for the trajectory of the 10yr Treasury yield. The market discount for the terminal fed funds rate is back up peppering the 5% area. The expected delivery of a 75bp hike will move the effective funds rate up to 3.83%. That's still well over 100bp below where the market expects the effective fund rate to get to, and there are various ways to get there, with most now expecting a slowing in the pace of delivery ahead.

> *Its in the Fed's interest to keep the notion of a possible additional 75bp hike alive in the market psyche*

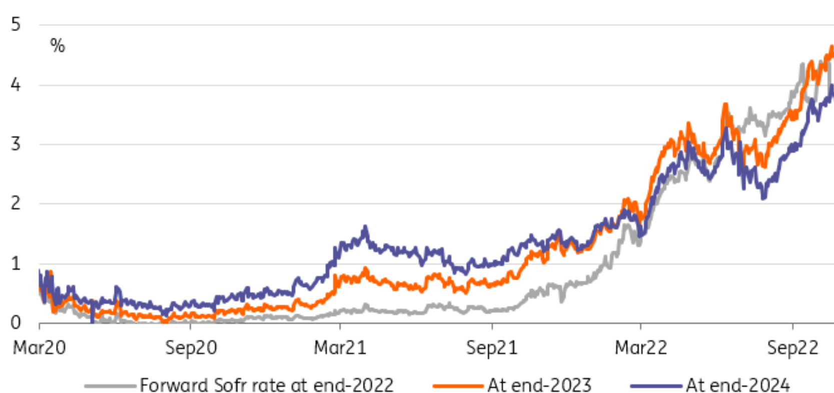
That said, it is unlikely in our opinion for Chair Powell to provide any firm guidance on the likely size of the 14th December hike. In fact its in the Fed's interest to keep the notion of a possible additional 75bp hike alive in the market psyche. Stating too clearly that they intend to go for, say a 50bp hike, would reduce the impact of the 75bp delivered, likely resulting in an offsetting loosening in financial conditions. It's far more likely that the Fed shows a non-committal "see how the data evolves" approach.

The other issue is whether the Fed decides to talk about market technicals. There is a running US$2.2tr going back to the Fed on the overnight reverse repo facility, reflective of an ongoing excess of liquidity in the system. Such is the size of that excess that the SOFR rate, effectively the general collateral rate, has been dragged down to the 3% area at times. It has even been below 3%, which is not a great look as the fed funds floor is 3%. The rate the Fed pays on the reverse repo window is 3.05%.

So far the Fed has viewed this through the prism of a facility that continues to do its job. That's fair to a point. But during deeper moments of reflection, there must be a nagging feeling at the Fed that this is not an ideal set of circumstances, and a means to correcting this is through faster balance sheet run-off. The balance sheet run-off will ultimately cumulate to a point where it begins to materially impact the liquidity excess, but that will take some time; likely another few quarters.

A final point that the Fed may or may not opine on is its net income account. Two issues here. It will be interesting to see whether the Fed addresses the rising price to be paid on excess reserves, which are compensated at the rate of 3.15% currently, and that likely goes up by 75bp, in line with other rates. And the cost of servicing the monies at the reverse repo fcility at 3.05%. We calculates these as running at US$170bn annualised currently. Not a masive issue, but there has been minimal commentary on this from the Fed to date.

Pivot or not, the curve is pricing a terminal rate around 5%



Source: Refinitiv, ING

Not much to gain in chasing the Fed pivot

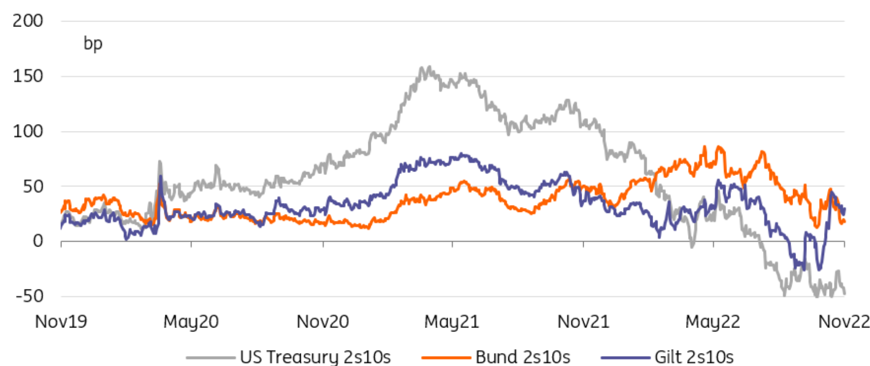
Hopes of a slower pace of Fed hikes starting in December shaved 30bp from 10Y Treasury yields. For Bunds, the move, peak to trough, was even larger, courtesy of a more cautious tone from the European Central Bank at last week's meeting. The Reserve Bank of Australia (RBA) confirming it has reverted to 25bp hike increments at its November meeting was enough to support a bond market already prone to confirmation bias. All point to a diminishing ability to surprise on the

dovish side today, especially given the risk of higher inflation and a central bank reluctance to let financial conditions ease back after a year of painstaking tightening.

All point to a diminishing ability to surprise on the dovish side today

Curve reaction to the much discussed pivot, in reality just central banks reverting to a more natural pace of hikes after policy rates soared past their neutral level, has actually been ambiguous. Appetite for duration and for risk assets has clearly benefitted but swap curves have been reluctant to shave off hikes. Exhibit one is the Fed funds swap curve still pricing a terminal rate around 5%. The result is that short bonds failed to join in on the pivot party, resulting in a flatter curve, hardly what you'd expect from more dovish central banks. The same flattening has been evident on the German curve.

Curve flattening in EUR and USD reveals an ambivalent attitude towards central bank pivots



Source: Refinitiv, ING

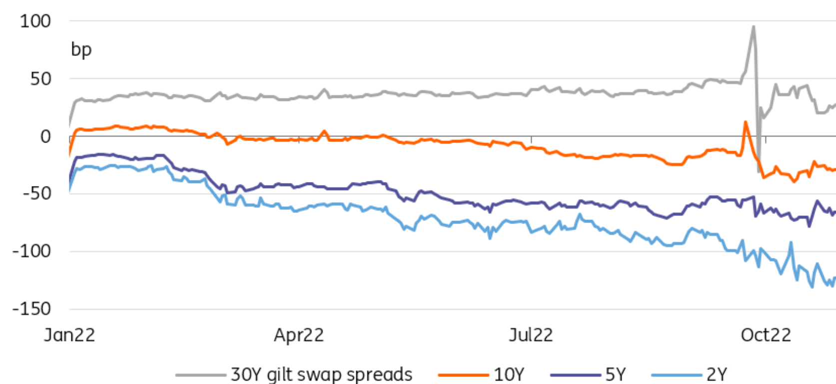
A reassuring start to BoE quantitative tightening

Bond markets got a rare piece of good news yesterday in the form of a successful first Bank of England gilt sale. To be fair, odds were stacked in favour of a well absorbed operation with a small size, focused in the sector of the curve where bond scarcity is the most acute, and as the BoE promised to refrain from long-dated sales, thus materially denting their duration impact. As expected, the greatest demand was for the shorter-dated bonds. Those looking at the glass half empty will point out that the operation confirms very limited appetite for gilt duration risk after last month's debacle.

The operation confirms very limited appetite for gilt duration risk after last month's debacle

For now, we remain cautiously optimistic. If there is a source of instability in the gilt market, it is more likely to emerge from markets questioning the BoE's tightening strategy after this week's meeting, or from an underwhelming budget. 10Y gilts already trade through 3.5% in yield, when the swap curve is pricing a terminal rate around 4.75%. A further rally is entirely possible but a necessary condition is further deflation of BoE hike expectations, a tall order if the Fed doesn't deliver on pivot hopes.

Swap spread tightening points to gilt scarcity at the front-end



Source: Refinitiv, ING

Today's events and market view

Although most of the PMIs services released this morning are second readings, the Spanish and Italian are first prints. Even if the ECB has put less focus on the job market than the Fed, today's German job data should also play a role in dictating market direction.

Supply consists mostly of Germany selling 2031 green bonds in small amounts.

If supply is anecdotal, ECB speakers should provide some action ahead of the Federal Open Market Committee (FOMC) meeting. Gabriel Makhlouf, Francois Villeroy, and Joachim Nagel make up today's speakers list.

The Fed's November FOMC meeting is widely expected to deliver another 75bp hike. There will be no update to the statement of economic projections but any hint on the outlook for growth and inflation in Chair Jerome Powell's press conference will be parsed by a market hoping for a smaller 50bp hike at the December meeting. We think markets went a long way towards pricing a Fed pivot so chances of a disappointment are significant. The late October rally in Treasuries is at risk, but the effect should be felt further afield with euro rates at least as much exposed.

Authors

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

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

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