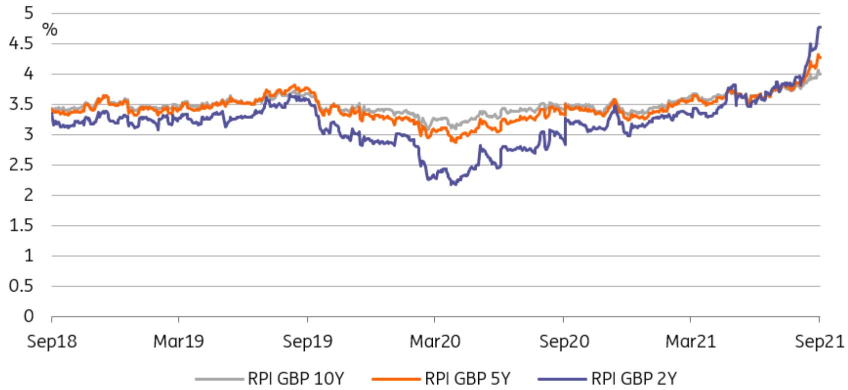
Rates Spark: Frayed nerves

The rates market sell-off has extended, albeit losing some steam. While the GBP inflation narrative grabbed the headlines, USD rates dynamics indicate it is more a repricing of monetary policy. Only the ECB is distancing itself from the hawkish turn, at least with some success as steady EGB spreads and wider UST/Bund suggests.

The monetary policy repricing extends

The bond market sell-off extended yesterday with UK rates in the lead. It was in the wake of the Bank of England meeting that yields turned sharply upwards. The energy crunch and supply constraints are helping to push UK inflation swaps to record levels, and comments by MPC members trying to put the current spike in inflation into perspective have failed to calm markets.

GBP RPI inflation swaps reflect the UK inflation scare

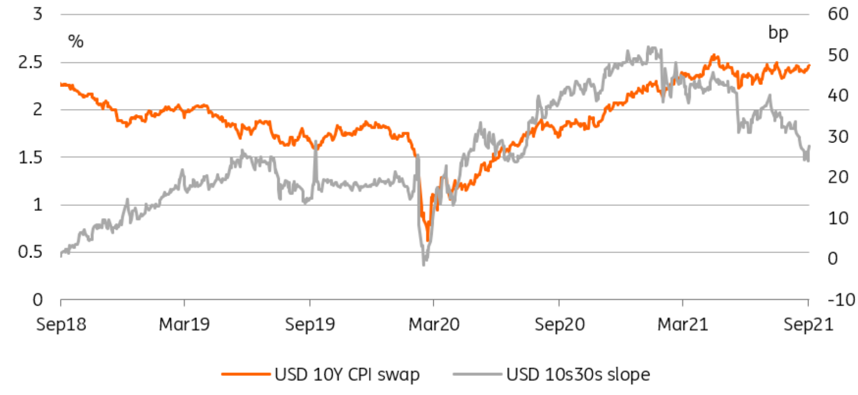


Source: Refinitiv, ING

US markets are further adjusting to a perceived change in monetary policy

But the other sizeable market moves were seen in the US, where the Fed's Bullard had suggested the Fed was on track to announce the taper in November, and also that he saw a case for starting to shrink the balance sheet next year. 10Y Treasury yield touched 1.55% and 30Y yields were up by 10bp on the day. However, taking a step back draws a more nuanced view beyond the inflation scare. In fact, the 10Y breakeven inflation rate has merely moved to the upper end of the range it has been trading in since the start of June. That the 10s30s yield curve – despite the large move in outright yields and resulting steepening – is still at a relatively flat level of somewhat above 50bp, where it has been oscillating for the latter part of this month. And the feeding through of higher yields in stock markets, it points to markets further adjusting to a perceived change in monetary policy. It also gels with the ratchet higher in front end rates and the cheapening of the 5Y on the fly versus 2Y and 10Y rates.

The US curve seems less worried about inflation getting out of hand



Source: Refinitiv, ING

The bar for raising interest rates is substantially higher than it is for the bond buying taper

It all reflects a base case to which we would also subscribe where the Fed will eventually hike more aggressively as we think inflation will turn out to be more sticky. That said, the verdict on this is still out, and the Fed still subscribes to the temporary inflation theme. As Fed Chair yesterday highlighted again, the bar for raising interest rates is substantially higher than it is for the bond buying taper. For the rise in yields to extend the data will have to play along. We did see upside surprises recently, but yesterday for instance saw consumer confidence still under pressure. Markets taking a step back again cannot be dismissed.

The ECB's steady hand

Amidst all the market turmoil and inflationary headlines the ECB's steadfastness stands out. President Lagarde again highlighted the bank's position that inflation would eventually turn out to be transitory and warned against monetary policy overreacting. While assurances have not been able to entirely shield EUR rates from the spill-over effects, the gap to US rates in the 10Y has widened by more than 10bp since its recent low of 160bp in mid-September and we it think the diveregence theme is going to regain importance going forward.

The diveregence theme is going to regain importance going forward

That the intra eurozone bond spreads have remained relatively contained is also testament to a market lending credibility to the ECB's dovish playbook. The 10Y BTP/Bund spread has seen some widening, and so has Greece's bond spread as some uncertainty remains surrounding the post-PEPP nature of bond buying, but other spreads have seen very limited spill-over from the risk-off felt in stock markets for instance.

Today's events and market view

The ECB's central banking forum puts the limelight on the global central bank heads. But before Lagarde, Bailey, Powell and Kuroda have a chance to address the current situation in the late afternoon, ECB executive board members will appear on various panel sessions, including Chief Economist Lane.

In supply Italy sells 10Y bonds and 5Y floating rate bonds for a total of up to €4.25bn. Germany reopens its 10Y for €4bn.

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