Rates Spark: Hawkish flattening drive

Rates push higher and curves flatten as the hawkish message from the latest central bank meetings sinks in. The decisions have also highlighted policy transmission issues that have to be overcome as negative rates are left behind. Today's eurozone PMIs underscore the growing economic pain the ECB is willing to tolerate, as it focuses on inflation

Gilts lead the sell off, caught between BoE and fiscal measures

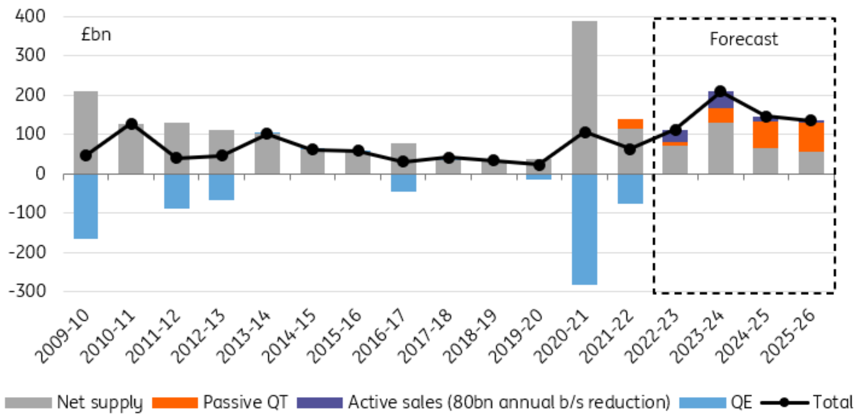
As the hawkish message of this week's raft of central bank meetings sinks in, rates markets remain under pressure with front to intermediate rates underperforming initially. The German 2Y 10Y curve came close to inversion, re-steepened only as 10Y Bund yield pushed towards 2%.

Yet it was Gilts that led the sell-off. At first sight, it was surprising as the Bank of England underwhelmed market expectations with a smaller than expected 50bp hike, but the Bank later added that the impact of the government's fiscal package would only be considered at the next meeting. With the promise to act forcefully if necessary that leaves the door open to substantial increases further down the road – 75bp not excluded with three Monetary Policy Committee votes in favour already this time around.

It gets uncomfortable for Gilts amid quantitative tightening and fiscal spending

However, it is also the Gilt supply dynamics weighing heavily. The BoE announced yesterday its plans to kick off active sales of its bond holdings in October. This would amount to the portfolio shrinking by £80bn over the next 12 months, half of that sales, the other half passive roll off. Those numbers were not entirely unexpected, but amid current market conditions and given that the government's energy-related spending plans could create unpredictable upside risks for Gilts issuance, this puts private Gilt investors in an uncomfortable position. We would not exclude 10Y Gilt yields at 4% soon.

Fiscal measures and QT add up to a daunting amount of Gilt supply



Source: Refinitiv, ING

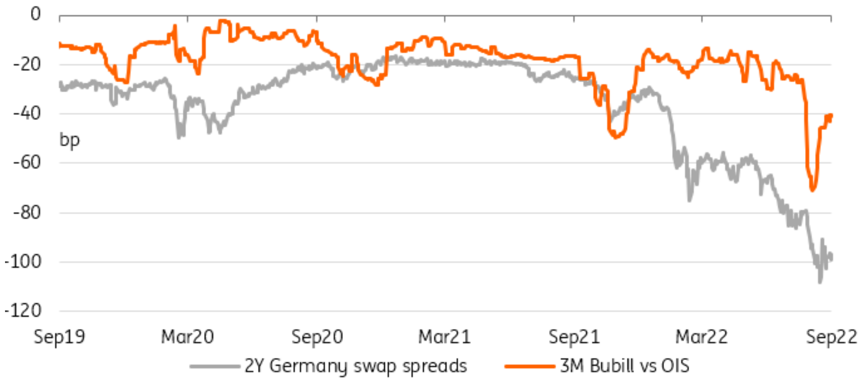
Transmission and cost issues as rates are hiked

A more technical aspect faced by central banks as policy rates are lifted from zero or below into positive territory was highlighted by the Swiss National Bank yesterday. It hiked the key rate by 75bp to 0.5%. But to ensure that the market rate actually follows the policy rate higher, it introduced what essentially boils down to a reverse tiering system. Sight deposits are now remunerated at the key rate up to a multiple of individual banks' reserve requirements, and anything above does not earn interest. Crucially, that will compel banks to participate in the SNB's repo transactions and bills issues have been introduced alongside to mop up this remaining excess liquidity, ensuring that the overnight rate actually trades at the policy rate.

Rate hikes are not properly transmitted into all corners of the money market

The European Central Bank has also faced the problem that its rate hikes are not properly transmitted into all corners of the money market. Collateral scarcity is affecting core rates with Germany's 3m treasury bills still trading some 40bp below ESTR OIS (euro short-term rate overnight indexed swap) for instance. The ECB has prevented at least a worsening of the situation by remunerating the vast government cash holdings at national central banks that would have otherwise pushed into the tight market for collateral. But it is only a temporary fix and the ECB may eye other central banks' approaches, in this case, the SNB's issuance of central bank bills – which is essentially converting excess liquidity into collateral. It does not address the issue of the ECB being left with rising interest costs as it has started to remunerate banks' excess liquidity holdings.

Collateral scarcity means higher ECB rates don't transmit fully to German bonds and bills



Source: Refinitiv, ING

Today's events and market view

The eurozone PMIs are expected to drop further below the 50 threshold as high energy prices bite and force manufacturing production cuts. Yet ECB officials have already started to prepare markets for upcoming pain, signalling their intent to remain focused on inflation and hike rates despite an economic downturn. This had boosted the flattening dynamic of yield curves, and while yesterday it was already close, the Bund curve should eventually follow the OIS and swap curves into inversion.

Gilts markets will focus on today's fiscal event and what it will mean for issuance. At least equally important will be the implications for the upcoming BoE policy decisions, with the Bank having already warned that the government's energy package will increase medium-term inflation pressure.

Elsewhere, we will follow comments from the ECB's Martins Kazaks as well as Bundesbank's Joachim Nagel alongside the SNB's Thomas Jordan. Later in the day, Fed Chair Jerome Powell will open a "Fed Listens" event with Vice Chair Lael Brainard and the Fed's Michelle Bowman.

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