

Rates Spark: Hawkish risks in the Fed dots

Risk sentiment has started to show more resilience towards the gyrations surrounding Evergrande, although it is certainly not the end of the story. The focal point today will be the Fed meeting, as money markets have room left to price a hike in 2022 in accordance with potentially shifting dots.



Market impact likely to be most acute on a re-shuffling of the dots

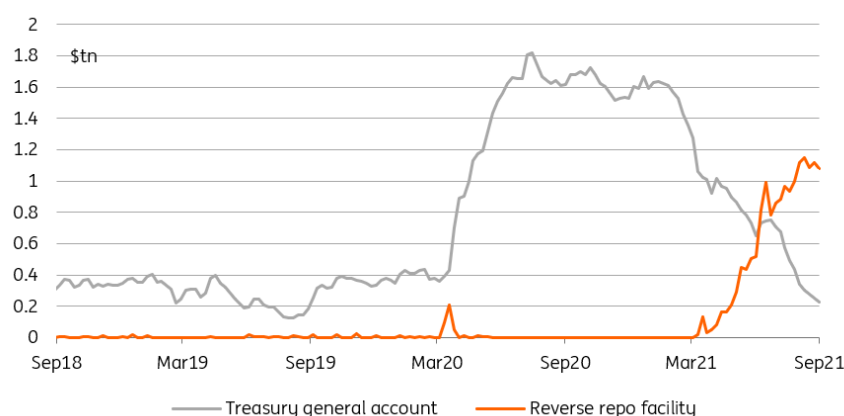
The rates market will focus on three things. First, on any hint of an imminent taper. Second, on any re-shuffling of the dots. Third, on any finessing in repo operations. The first is all about the back end. While a taper announcement is not expected, any nod at all towards it would likely pressure long end rates higher. The second is more of a front end influence. Currently the 2yr yield in the 20bp area contains only a minimal rate hike risk, and that extends right into 3Q 2023. Bring forward the dot by one year and that 2yr discount looks wrong. Upward pressure on the 2yr yield should obtain. This is the most likely outcome from this meeting to have a material effect.

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reshuffling of the dots and any finessing in repo operations.

The third element is all about the technicals of money market liquidity. The Fed does not routinely opine on this, but given the persistent USD1tr per day going into the overnight reverse repo facility it is something that may be addressed. The tone so far is that this is nothing short of what the Fed had expected, and it is acting as the safety valve that it was intended to be. Where we go to in terms of excess liquidity is in part outside the Fed's control. To the extent that the US Treasury has practically spent down its balances at the Fed there is reduced upward pressure on volumes. At the other extreme, the debt ceiling is preventing a mop up of liquidity through bills issuance.

A reduction in the Treasury general account is pumping liquidity into the market



Source: Saint Louis Fed, ING

Then there is the planned permanent repo facility which the Fed is currently finessing. This is something that will come to the fore when the Fed tapers, and ultimately takes reserves from the system. Here, the Fed would be adding liquidity (as opposed to draining it as they do with the reverse repo facility). The biggest talk here is on counterparty eligibility, where as wide as a net as possible would minimise potential future pressures. At the same time, there is a body of opinion that suggests limiting this to the domestic insiders. It is unlikely this becomes a large talking point at the press conference, but it will in all probability show up as one in the subsequent minutes.

ECB: Open discussions into December ...

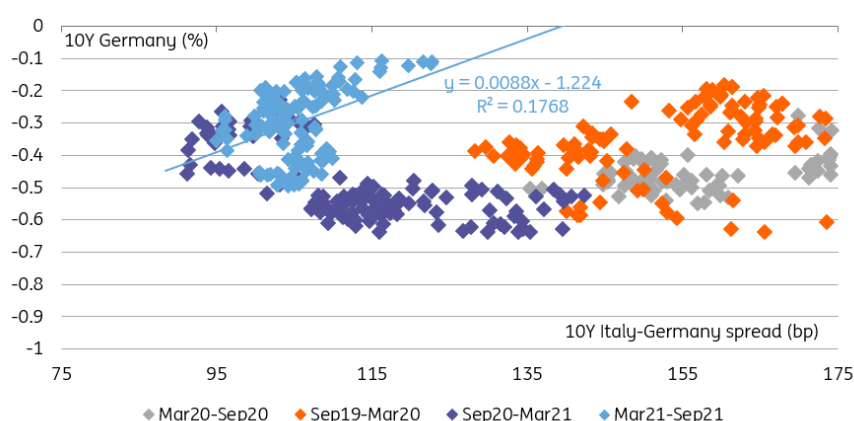
The recent speeches and interviews of ECB officials have served to highlight the wide ranging topics up for discussion and the complexity of the decisions that have to be taken by the central bank in December. For now the phrase coined by France's Villeroy, "vigilant, but not worried" describes the common stance on the inflation risks, but how that translates into concrete measures is still unclear. Tweaks to the forward guidance, purchase programme parameters and liquidity operations are all on the table.

How 'vigilant, but not worried' translates into concrete measures

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On Monday, the ECB's Schnabel sought to clarify the changing role of asset purchase programmes for the ECB's policy stance. In the context of forward guidance it is the purchase programmes' signaling channel that gains importance, reducing the uncertainty of the ECB's interest rate path and acting as "commitment device". The programmes' end date become more relevant than the actual volumes, though flexibility to conduct purchases still serves as an important backstop. So much for the theory.

Expectations of ECB easing allow Italian spreads to tighten on rallies



Source: Refinitiv, ING

.. and the hawks have been quiet so far

Theory already highlights potential compromises and trade-offs along purchase volumes and flexibility. Bank of Greece's Stournaras, an outspoken dove, voiced more concrete ideas yesterday on what he believes should be the outcome. The regular asset purchase programme (APP) should inherit the flexibility of the PEPP, including that it continues to buy Greek bonds (which at the moment is only possible through the PEPP as the minimum rating criteria is waived). He keeps open the option to extend PEPP, though.

ECB communication so far has been eminently dovish

The underlying tone of ECB communication so far has been eminently dovish, also because the usual hawks have been relatively quiet thus far. Regarding the inflation risks the strategy has been to underscore the temporary nature of higher prices, also as a way to help preempt these from feeding into upcoming wage negotiations. That dovishness should start sinking in, but for now markets attention and drivers also of EUR rates lie outside - in the US and China - with the December ECB meeting still a stretch away. Yet periphery spreads being contained throughout the latest risk-off episodes with the 10Y Italy/Bund still closer to 100bp, show where expectations are

leaning.

Today's events and market view

There is little in terms of data to distract markets from the upcoming Fed meeting. US money markets have room left to price a hike in 2022 in accordance with potentially shifting 'dots' in the Fed's interest rate forecast. However, the unresolved situation around Evergrande, having missed interest payments on bank loans and facing bond coupon payments on Thursday, creates headline risks.

In supply, Germany will reopen its 15Y bond for €2.5bn today. The bonds subsequent reopenings scheduled for the fourth quarter have been reduced by €1bn with the release of the debt agency's latest funding plan yesterday. It was the only change in capital market issuance plans, next to a €3bn reduction of the money market funding target. Elsewhere, Portugal has announced a bond exchange auction for today.

Authors

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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