

## Rates Spark: I'm just saying

Fed Chair Jay Powell will be torn today. A bit of inflation is a good thing; it's what the Fed has wanted. But too much anticipation of it is not good, as it tightens policy prematurely. And how to frame the front circumstances, where SOFR risks going negative? Not easy, so he might ignore it. In contrast, the ECB's Christine Lagarde has taken on the clear task of talking down rates, it seems. While her talk has yet to translate into higher QE volumes, a decoupling from the US trend looks unlikely



Fed Chair, Jerome Powell

### A Fed focus first up, as a frothy underpinning comes to the fore

Federal Reserve Chairman Jerome Powell will deliver his semi-annual monetary policy report to the Senate Banking Committee in the European afternoon. He has the opportunity to calm the global rates sell off. As long as stock markets don't cave in, we believe that he will refrain from micromanaging markets and stick to the current dovish policy stance with a nod to more healing being necessary in the job markets. Letting the economy run hot risks a higher inflation premium in long end yields.

*If higher yields reflect economic optimism, so be it*

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If the recent comments by other Fed officials are any guidance then he is unlikely to sound particularly concerned by higher yields. Richmond Fed's Tom Barkin was the latest to echo that view after John Williams, his opposite number from the New York Fed, made such remarks late last Friday. If higher yields reflect economic optimism, so be it. Further fiscal stimulus is around the corner, but Treasury Secretary Janet Yellen's comments on potentially higher corporate and capital gains taxes might provide a new angle that could take the froth out of risk assets and dampen the rise in yields.

## **It's complicated though. The long end needs some protection. The front end needs, "something".**

That said, Chair Powell faces some quite intricate issues, that he may or may not address.

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*At the moment, long-dated rates are getting minimal protection from the Federal Reserve.*

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The first one centres on the pivot from worries about deflation to inflation. This should be viewed as a success, and the Fed will want to ensure that the pendulum continues to point in that direction. But at the same time, Chair Powell needs to ensure that the inflation discount remains in check. At the moment, long-dated rates are getting minimal protection from the Federal Reserve. It is true that the Fed is buying bonds, and the wider premise of policy is undoubtedly easy. But Chair Powell needs, at some point, to check the up move in long yields if it is deemed to be getting out of control. Some carefully managed messaging in that direction is warranted, as there is no point in the Fed having super easy policy in place on the one hand while on the other allowing the bond market to tighten policy through higher long rates.

The second issue centres on the technicalities of the front end.

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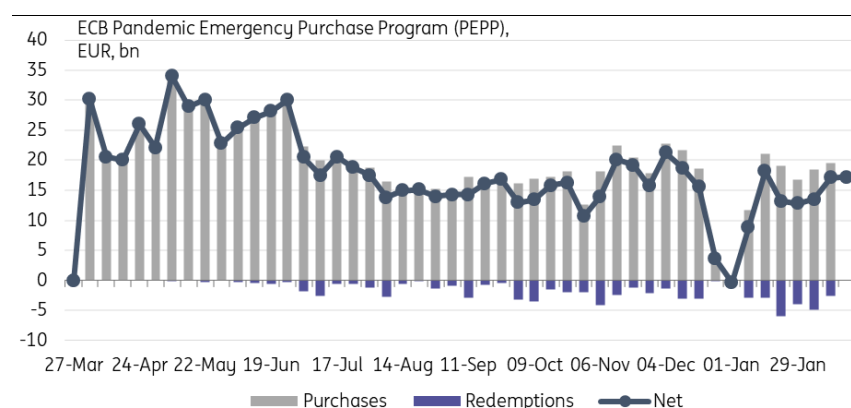
There is a mountain of liquidity swashing around, coming from the Fed's quantitative easing programme. On top of that, a chunk of the US Treasury's \$1.7tn cash balance at the Fed is set to be spent. This will then show up in bank reserves, technically adding to the supply of liquidity, and putting downward pressure on rates. The US Treasury does not intend to replace this bills issuance, as they instead morph issuance into longer dates over time. Shorter dates tend to be more repo-able than longer dates, and so there will be less available collateral swashing around. That combination is a recipe for downward pressure on SOFR, now at just 3bp. While SOFR is not the Fed's policy rate, it will not want to see it trade negative. A hike in the rate on excess reserves

will help, but will likely need to be 10bp rather than the 5bp talked of.

## And then the ECB - hard to know what the ECB really wants here; a bit of the US magic maybe

While EUR rates got dragged higher alongside the US, compared to the Fed, the European Central Bank has an easier job in defending its pledge to maintain favourable financing conditions. There are technical factors pushing inflation temporarily higher, but the economic outlook is decidedly less rosy. Not least with the vaccination efforts lagging behind and even fears of a third wave making the rounds as infection rates remain high and virus mutations spread.

## ECB is "closely monitoring" higher yields, action has yet to follow



Source: ECB, ING

ECB president Christine Lagarde's comments that the central bank was "closely monitoring" the increase in nominal yields struck a chord with EUR rates markets. That comment was later echoed by Banque de France Governor Francois Villeroy. Yield curves bull flattened with 10Y Bund yields briefly dipping to -0.36%. For now, the ECB's verbal intervention has not translated into higher activity under its pandemic emergency buying programmes. Last week the ECB settled €17.2bn in net purchases, just a sliver more than the week before.

Markets will closely follow these volumes in coming weeks to see whether the ECB backs up its pledge to maintain favourable financing conditions with higher buying volumes. While we doubt that the ECB can completely decouple from a trend towards higher rates in the US, we think USD-EUR yield differentials are set widen further, to 150bp for the 10Y swap rate differential.

# 150bp

## Our target differential between 10Y USD and EUR swap rates

As the Fed lets yields climb, the ECB talks them down

## Today's events and market view

Fed Chair Powell's testimony to the Senate is the main event. Sticking to a dovish line is unlikely to stop the trend higher in rates, at best he can hope to slow it. Other speakers today include Fed's Lael Brainard discussing the central bank's maximum employment mandate. Data indicators today should point to a continuation of the reflation trade. The Conference Board's consumer confidence is seen holding up and the Richmond Fed manufacturing index is also seen slightly higher.

In Europe, we get the final inflation readings for January. With little else on the plate, the focus is on supply where the Netherlands tops up its 20Y green bond by up to €2.5bn. Getting that out of the way could help EUR rates to step out of the slipstream of rising US rates.

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