Rates Spark: Jumpy at both ends

Many will disagree that the Fed has already hiked rates, but it has. Just by 5bp, and only techncial, but there is still an impact. Pricing the front end with the excess of liquidity is tough, but it still looks too low (in yield). The long end looks a bit lost now, having flattened dramatically, and then steeper. But inflation? No fear there apparently

Source: Shutterstock

The mixed pressures affecting both extremities of the US curve

Ultra front end rates have been successfully coaxed higher by the 5bp of hikes executed by the Federal Reserve in the rate on excess reserves (now 15bp) and in the reverse repo rate (now 5bp). But it has been heavy lifting. Even though the Fed has engineered technical hikes of 5bp, the effective funds rate and the secured overnight financing rate are up by 4bp apiece (to 10bp and 5bp respectively).

One positive development is that ultra front end bills rates are no longer printing negative. We'd argue this has just as much to do with the change in the verbal tone and the bringing forward of the median dot to 2023, but the Fed will take it in any case. Yet despite this, ultra-short bills rates are still below the 5bp attainable from the reverse repo facility, leaving the latter relatively attractive.

And indeed the volumes going back into the reverse repo facility rose again yesterday, to a new record at USD765bn.

> *It seems to us that the 2yr is remaining remarkably calm*

Despite the froth of liquidity in the front end, it seems to us that the 2yr is remaining quite calm. At 20-25bp there is very little implied fretting about a 2022 rate hike. Only a 2023 hike is discounted. Yet those dots can still creep shorter. To us a 2yr yield closer to 50bp would make more sense. But at the same time, 50bp would be quite a bargain given where adjacents further down the curve trade.

Further out the curve, clearly since March long end rates have been drifted down. The Fed gave them another push. That was not the Fed's intention, but given the bond market mood that was a reasonable outcome. This bond market is worried. Not about this year, but the years into the medium term. Also there is a rump of demand that continues to feature as a driver.

> *If this bond market is not going to fret about inflation, then it will flatten on a trend basis*

If this bond market is not going to fret about inflation, then it will flatten on a trend basis. And especially if the Fed eventually hikes, by which time it will be flattening from both ends. What could obstruct this? Tapering, potentially, as tapering is a bigger problem for the back end than it is for the front end.

> *But likely still in the end with higher rates along the curve*

Although it is more the QE unwind that would be the actual problem. The tapering would only be an issue as it would signal a point in the future when there would or could be a QE unwind. We like the idea of long dated market rates snapping higher and steepening the curve from the back end as the economy booms, but we find ourselves continually lurching back to the comfort of flatteners as the path of least resistance (but, likely still in the end with higher rates right along the curve).

Setting the eurozone apart from the US

While the 10Y US rate was almost back to where it was before the FOMC meeting, EUR rates are actually back to where they were right after the FOMC. Given the lower starting point from which EUR rates are eyeing the upside it is tempting to stick with a steepening view. The Eurozone is indeed in a very different economic situation compared to the US, making some of the curve dynamics that spilled over from the US feel out of place, especially the flattening at the very long end of the curve.

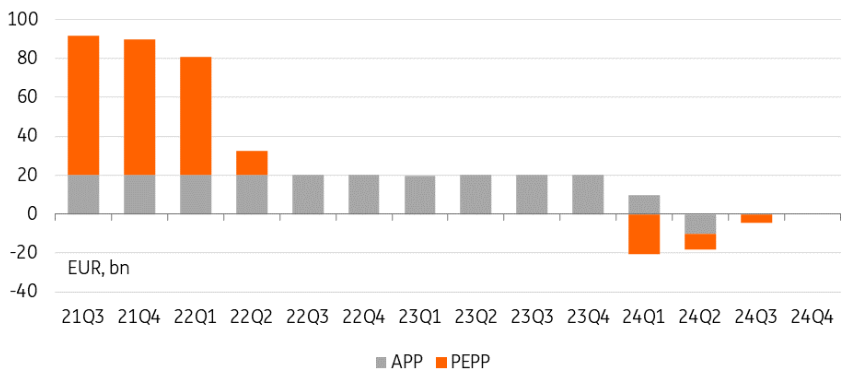
Indeed, we also see more steeping in the longer run, but we would also caution not to underestimate any renewed near-term flattening in sympathy with the US – or even just on the back of the ECB's current dovish tilt going into a summer usually also marked by lower supply activities. Only yesterday ECB President Lagarde struck dovish tones again in her appearance before a EU parliament committee. She acknowledged the brightening outlook, but stressed rising market rates still posed a risk to the recovery. She flagged that rate cuts are still a possibility.

Still room to price in some more ECB support for the bond market

The survey of monetary analysts that the ECB released at the end of last week also suggests that the expectation of market participants still leaves room to price in some more support for the bond market. It revealed a base case expectation of the ECB ending the pandemic emergency purchase programme's (PEPP) net buying at the end of 1Q22, crucially without any cushioning anticipated through larger buying via the ECB's other programmes.

For now the ECB's weekly purchases via PEPP are plodding along at a pace more or less in line with the higher purchase targets the market got accustomed to (€19.4bn last week). Combined with dovish talk this has helped to largely shield higher yielding corners of the European fixed income markets from the hawkish Fed, and should help to maintain carry friendlier conditions over the summer. The 10Y spread of Italian bonds over Bunds for instance had widened from just above 100bp to 108bp in the wake of the FOMC induced volatility, but has since recovered back to 104bp. French bonds fared relatively well yesterday as confidence was boosted by regional elections which seemed to indicate less of a risk from the political far right.

ECB survey of monetary analysts' median forecast of monthly PEPP/APP buying



Source: ECB, ING

Today's events and market view

Fed Chair Powell's testimony to Congress on the central bank's response to the pandemic will be the main focus. While this takes place after the European close, the Fed's Daly and Mester will already speak earlier. With little other data to trade off the policy implications for US rates should remain in the driving seat for now, however it is likely that the ECB's chief economist Lane as well as Isabel Schnabel in the evening will try to force a wedge between the USD and EUR with continued dovish rhetoric.

Another layer of volatility is added by supply activities with Spain having mandated a new 10Y bond yesterday – as widely anticipated – and the Netherlands selling up to €2bn in 15Y bonds. Any steepening on the back of supply could provide buying opportunities for those looking for flatter curves over the summer, and many will already eye the impending EU bond deal next week as just that.

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