Rates Spark: Late-cycle dynamics

Systemic concerns linger and, despite the latest central bank hikes, markets are now focusing on first rate cuts. Traditional late-cycle dynamics with yield curves resteepening are gaining traction. Next week's inflation data should be a reminder that at least the European Central Bank is still a stretch away from calling its inflation problem solved

Central banks hiked, but the market is focusing on cuts already

The past two weeks has seen central banks across the globe still hiking rates. Yet, despite all displays of confidence and efforts to shore up the system, financial stability concerns are not going away. Markets are growing used to the idea that we have probably seen the last of the tightening from central banks and now the prospect of rate cuts is moving into focus. The late-cycle dynamics are taking over and resteepening the yield curves. In the US, money markets are now hardly discounting any chance for another Fed hike in May. Instead, they are discounting at least three 25bp cuts before the year is out.

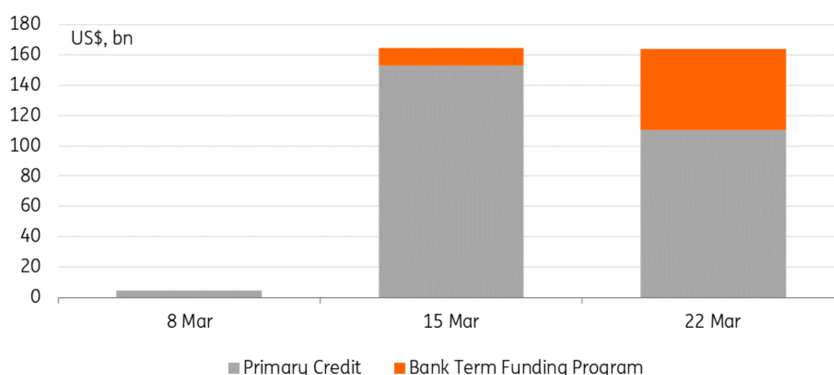
Officials had been unsure of the impact the market turmoil would have, but by the week we are getting more information on how it has impacted the flow of liquidity in the system. In the second week since the failure of Silicon Valley Bank, the combined recourse to the Fed's primary credit and

new bank term funding programme has even slightly declined to just below US$164bn, though with more now going in to term programme. The latter is up to US$54bn from US$12bn in the first week.

The broader banking system is probably still seeing a drain of its deposit base

As encouraging as the latest Fed's data is, suggesting that at least there are no others yet in need of an immediate lifeline, it should not distract that the broader banking system is probably still seeing a drain of its deposit base. Hinting to that, in the week to 22 March money market funds in the US saw another US$117bn of inflows, taking the total for the last two weeks to US$238bn, based on ICI data. This is a quick acceleration of a trend that had already been driven by the rise in interest rates. We are witnessing a tightening of financial conditions in real time, whose economic impact will have yet to be determined.

Discount window borrowing was stable, but shifted into the new term funding programme



Source: FRED, ING

Current inflation is still running too high

The Bank of England got a taste of still hot inflation just this week. This will have helped to tip the scales in favour of the 25bp hike that was delivered yesterday and also in favour of the still overall more balanced messaging – notwithstanding wider measueres of price persistency.

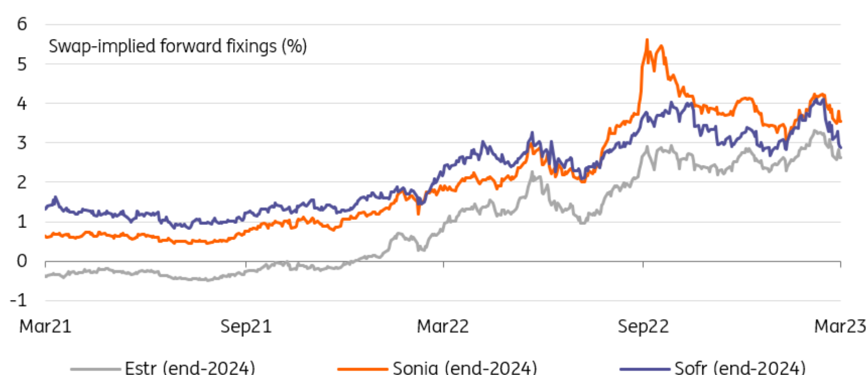
Next week's focus will first turn to the eurozone where we will get the preliminary inflation reading for March. While headline inflation is seen to further edge back from its peak by falling to below 7%, the more relevant core inflation rate is still expected to edge higher to a new record. That is the worrying trend in underlying price pressures that ECB officials had pointed to, justifying their hawkish positions before the banking turmoil.

The upcoming inflation data may embolden the ECB hawks again

For now, eurozone rates have fallen in line with the global late-cycle dynamics. While the ECB had still hiked by 50bp last week, it abstained from providing any further guidance. Even the most hawkish ECB members are now toeing the line that one has to await the data before concluding how much more tightening is needed. However, the next inflation release will be an important data point and may embolden the hawks again. That said, markets and officials alike will have to weigh current inflation against the prospects of a more lasting knock-on effects of the financial turmoil.

We will also see inflation data out of the US, with the release of the PCE deflator. The current market expectation is that the drop back of the month-on-month core rate to 0.4% will support the narrative that the Fed is close to the end of its hiking cycle.

Markets are cutting their 2024 rates expectations, especially in the US



Source: Refinitiv, ING

Today's events and market view

Concerns over financial system persist, and the flip-flopping of US officials over potentially broadening the deposit insurance does not help – do we have a problem or not? While there is still a base case scenario that we will further emerge from immediate banking stresses, it is also clear that the operating environment for banks is likely to stay more restrictive for a while. This justifies shaving of terminal rate expectations, but we would argue that there should still be some more distinction. Next week's eurozone inflation data should show that especially the ECB is still a stretch way from being able to call its job done.

In today's data the focus will be on the flash PMIs for March. One could argue that these indicators have been overtaken by recent events now that an additional financial tightening factor has to be reckoned with. Banking issues aside, the economic situation in the eurozone had been stagnating to begin with. As our economists point out, sentiment data has painted a relatively positive picture of the economy in February, but hard data for the first quarter shows little sign of a strong rebound.

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