Rates Spark: Lots to get excited about... next week

It's tough to get excited about this week. But next week is potentially quite impactful, and can impact sentiment in anticipation. We identify a tactical bond bullish tint, and separately, why money markets should keep a close eye on reserves mangement and debt ceiling complications

Tough to prompt direction in this market – but watch core PCE in the distance

It's been one of those weeks so far. A hugely impactful start on the inauguration of President Trump, but lacking on material impulse for markets, partly as it's not clear what to take seriously or what not. Data releases have been somewhat meh too. And it does not get much better on Thursday, as US jobless claims feature (expect an ongoing match in the 220k area, indicative of an ongoing firmish labour market).

The big one is next week in the guise of the core PCE data. For Treasury bulls, if this number comes in at 0.2% (or better) that would be a clean sweep of core inflation readings turning the corner again, this time in a positive-for-bonds direction. Even though the year-on-year rate would remain troublingly high (2.8%), base effects for the subsequent number of months would ratchet that YoY rate down to the sub-2.5% area. That, together with the ongoing upsizing in duration exposure from mutual funds is why we remain tactically bullish.

So why the sad bear face thereafter? We remain apprehensive of the tariff effect on US prices on reprisals, of any new tax cuts that might be implemented, and the elephant very much remains in the room (whisper it – the size of the US fiscal deficit, and another upcoming set of re-funding figures to refocus the market on it).

The Fed meets next week – pay attention to potential liquidity management aspects

The minutes from the December meeting noted that usage of the overnight reverse repo facility remained on a declining trend, reflecting money market fund reallocation to Treasury bills and private-market repo, which offered slightly more attractive market rates. This occurred against a tightening in market repo conditions, and continued increases in net Treasury bill issuance. At that meeting, the Fed also reduced the rate it pays at the reverse repo window by 5bp, back to flat to the funds rate floor. This adds to the attraction of market repo, and should correlate with further falls in use of the reverse repo window. Our view is usage of the reverse repo window will ultimately fall towards zero, barring some temporary spikes around month end.

The Fed may or may not comment on the above. Also interesting to see whether the Fed comments on the resurrection of the debt ceiling since 2 January 2025. While it's too early to expect a material market focus on it, the technical aspects of it are impactful. For as long as the debt ceiling remains in place and the Treasury employs extraordinary measures to avoid breaching it, there is a tendency to spend down the cash balances that it holds at the Fed. As these get spent down, they add to reserves in the system which in turn acts to counter the tightening effect of the ongoing quantitative tightening (QT) programme. In effect, hitting the debt ceiling forces the Treasury to be a net supplier of liquidity to the system.

Despite these complications, the Fed may well lay the groundwork for ending QT at some point in 2025. This is the case as excess liquidity (which we define as bank reserves plus reverse repo balances) is likely to hit levels that the Fed would prefer not to go below from the middle of 2025 onwards, partly depending on how the debt ceiling saga evolves. The key number here is US$3tn for reserves, representing about 10% of GDP. We are currently at US$3.5tn. So we're comfortable. At the same time, the reverse repo balance is running at US$125bn, and if that were to hit zero, then we'd hit some degree of tightness. That's close, as QT is running at US$60bn per month. QT may have to end by mid-2025 based off a simple extrapolation of this.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.