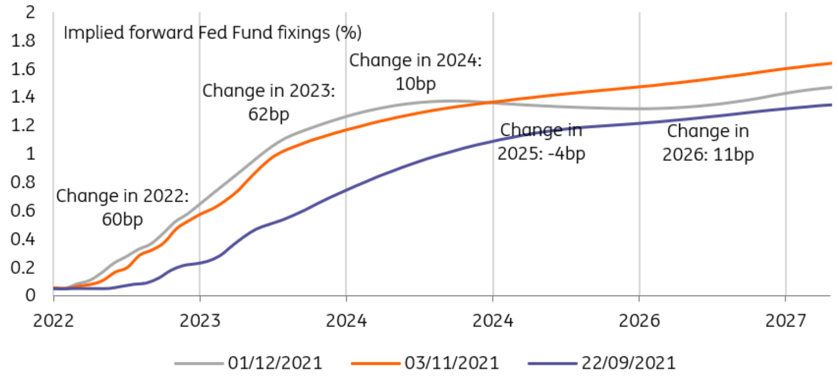
Rates Spark: Omicron inversion

The Omicron variant and the winter wave underway in many countries do not subtract from inflation worries – they add to them. Flatter curves are the logical consequence, and some real rates are moving higher too. The US front end continues to trade with a decent rate hike discount. Makes sense to us, especially as hikes are not expected till 2H 2022

The US front end tells a story – hikes are still coming

The likely outcome for market rates in the coming days will likely be a digital reaction to what science has to say on Omicron. Good and bad news has been reacted to so far, with the move lower in yields and acknowledgement that circumstances have in net terms veered towards the worst. But we await a clearer vision on this. We have not, as yet, had confirmation that a follow-through lurch lower in market rates is required, but what we can say is any material break below 1.4% (there is a key technical point at 1.385%) on the US 10yr could quickly take us back to the 1.3% area that we plateaued at through much of the summer. That would be quite a setback for higher end-year yield aspirations.

Despite Omicron, USD OIS are pricing just over 2 hikes next year



Source: Refinitiv, ING

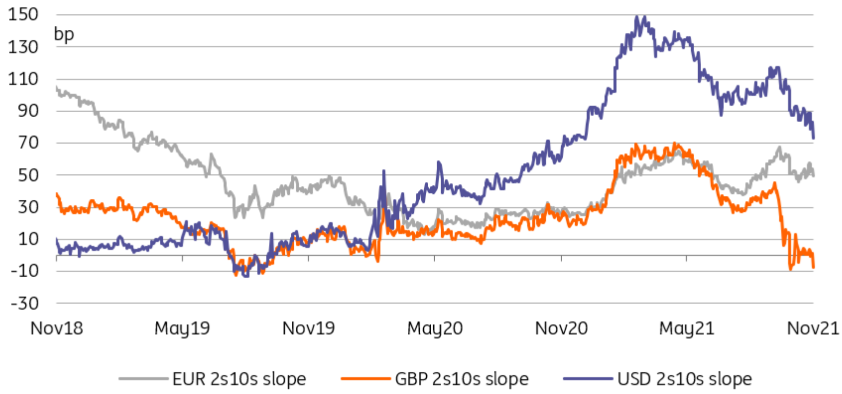
Gearing for Fed hikes still makes considerable sense

At the same time, the US front end is not taking out any of the rate hike discount. The 2yr remains in the 50-60bp area. Gearing for hikes still makes considerable sense. Remember the hikes are not expected to happen till the second half of 2022. By then, this latest Covid scare should be behind us. We don't have enough to suggest that that should change, and in fact Chair Powell has intimated that a closer scrutiny of inflation risks is warranted. Indeed, the inflation story, while often ignored by the fixed income market in the past number of months, has a persistence about it. If it won't go away, and it looks like it won't (at least not easily) then market rates will have to be ultimately tempted higher.

Near-term risks to affect mostly long-end rates

A winter Covid-19 wave is unwelcome news, and the wave of restrictions associated with them pose a threat to a near-term growth outlook that wasn't brilliant to begin with in Europe. Travel restrictions imposed since the discovery of the Omicron variant add to these concerns, even if they might be reversed within a few weeks, or months. The bias towards pricing negative news was evident once again on Tuesday and we expect markets, through the volatility, to continue trading with a downbeat tone into year-end.

Curve flattening makes sense both on inflation and Covid-19 risk



Source: Refinitiv, ING

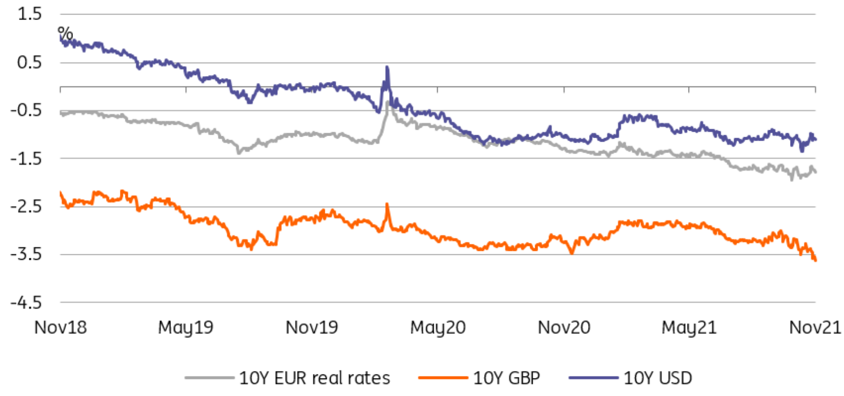
We expect markets to continue trading with a downbeat tone into year-end

In this context, the outperformance of long-dated rates makes sense, although they were probably lent a helping hand so far this week by month-end extension flows. More to the point, we would normally expect curves to bull-flatten on adverse developments. One could question if this applies at the onset of a tightening cycle where front-end rates could in theory price a more dovish path for policy rates on further Covid19-related worries . We think not.

While inflation fears keep front-end rates up

We are inclined to think of the near-term Covid risks to the outlook as factors that are transitory in nature, and that do not necessarily subtract from medium-term inflation fears. The surge in inflation on the other hand can no longer be described as transitory. Fed Chair Powell speaking in favour of faster tapering and yet another upside surprise in Eurozone inflation were clear reminders of that. In other words, it is entirely possible for both Covid-19 and inflation fears to be priced simultaneously by the market. This is most likely to occur via a flattening of the yield curve.

USD and EUR real rates have rebounded on the Omicron scare



Source: Refinitiv, ING

Unconditional monetary support can no longer be counted on

Another take-away is that despite very real near-term worries for the outlook, central banks are taking steps to prepare markets for less monetary support going forward. Powell warning of a faster taper yesterday was the most conspicuous example, but we have documented in previous publications that the ECB is more than aware of upside risks to its inflation forecasts. It took more adverse Covid-19-related news for real rates to notice, tentatively so far, but this is a clear sign that unconditional monetary support can no longer be counted on.

Today's events and market views

November PMIs will spice up an otherwise quiet European morning. Only the Spanish and Italian readings are first releases but the acceleration of the fourth Covid-19 wave in November, and worries related to the new Omicron variant to a lesser extent, increase the chance of downward revisions to preliminary readings.

Germany will auciton 5Y debt.

BoE governor Bailey is scheduled to make a public appearance on the topic of insurance regulation. The event doesn't necessarily lend itself to comments on monetary policy but, with the fate of the December hike on a knife's edge, we will listen in nonetheless.

If this fails to excite markets, ADP employment and ISM manufacturing should, alongside another testimony before Congress by Fed Chair Powell, where he is sure to be asked about inflation. While Powell likely has delivered the message he intended on tapering already (see above), he could take this opportunity to reinforce the message.

Authors

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

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@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 http://www.ing.com.