

Rates Spark: On tenterhooks

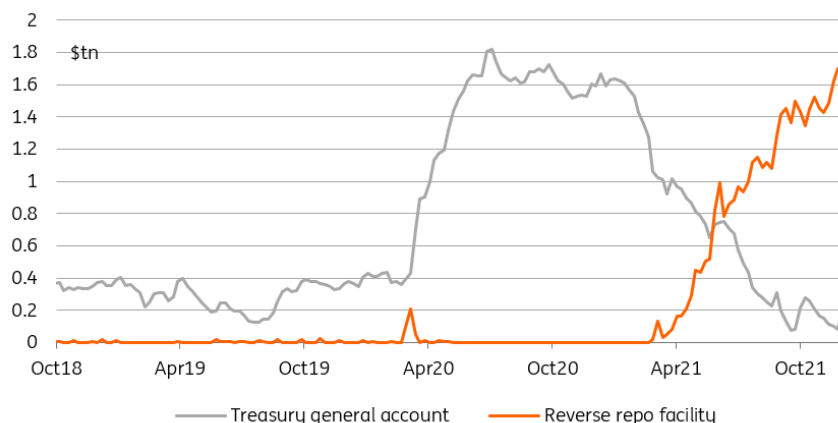
Gone are the days investors bought bonds with their eyes closed, confident in central banks' eventual support for the market. This makes rates all the more sensitive to second tier economic data, and raises the odds of volatile debt sales. A key driver is a Federal Reserve on a mission to tighten policy, and the latest minutes show they mean business



Market rates take the minutes as a cue to keep motoring higher

Both ends of the curve have ratcheted higher in response to the minutes. A flatter curve has also been a notable outcome; rate hikes are coming. Policy tightening acceleration has acted to push the 2yr yield well north of 80bp, and the 10yr has hit 1.7%. The latter has been driven by a rise in real yields. The 10yr real yield remains deeply negative (at -90bp), as nominal rates remain well below inflation expectations, but it is up 20bp since the beginning of the year, and just today up by almost 10bp. This is important, as rises in the real yield go hand in hand with an improved macro outlook. Inflation expectations have fallen, which is what would be expected from a more hawkish Fed that is increasingly prepared to act.

Quantitative tightening will also contribute to reduce excess liquidity being placed back at the Fed



Source: Saint Louis Fed, ING

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The minutes also went into the thought process when it comes to balance sheet reduction, which is code for a tightening in liquidity conditions. Currently there is some USD1.5tn going back to the Fed on the reverse repo facility, essentially this is the market handing cash back to the Fed that is swashing around the system. Crudely this could be taken out of the system, through balance sheet reduction over time. The minutes note the importance of the standing repo facility, which is a means to adding liquidity to the system as the Fed reduces its balance sheet, where market participants can lend collateral to the Fed to get access to liquidity. This is a buffer that allows the market to be in part self-regulating in liquidity management.

The latter is important, as the last time the Fed reduced their balance sheet, the system began to creak at a certain point as liquidity conditions tightened faster than had been expected. The standing repo facility offers a route out of any potential liquidity crunch, making it possible to get access to liquidity when required in a seamless fashion. This is all good preparation for a period where the Fed is either allowing bonds to roll off the front end (soft quantitative tightening) or outright selling bonds back (much heavier liquidity tightening which we have not seen before). We are not there yet as the taper needs to happen first, followed by hikes. But then these are the items on the Fed's menu where the tightening can be amplified as required.

2022 starts how 2021 ended, with inflation worries

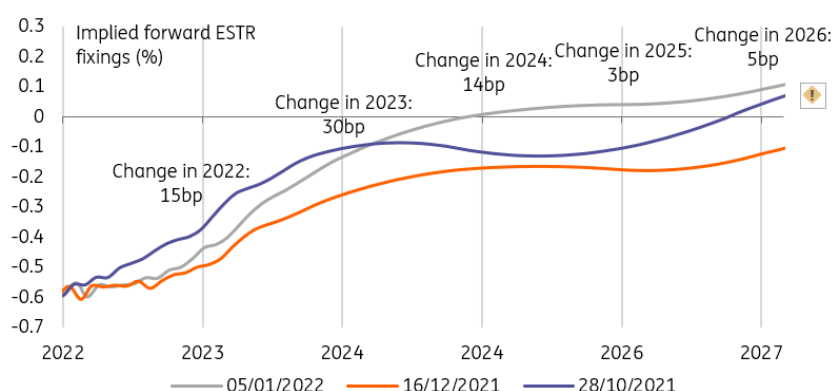
As January starts, rates markets remain on tenterhooks, as persistent inflation forces central banks into a tunnel vision-like focus on price dynamics. This makes releases such as yesterday's bumper 800k December ADP more impactful, even if most recognise that in any given month, the

gap with official US payroll data can be significant. The USD curve bear-flattening is the kind of reaction one would expect as faster job growth would add to the case for earlier Fed hikes. Note, however, that even slow job growth could be consistent with earlier tightening if it is symptomatic of constrained labour supply and a harbinger of wages pressure.

Even slow job growth could be consistent with earlier tightening

The same worries feel less pressing in the Eurozone but there is no shortage of ECB governing council members stressing upside risk to its inflation forecast, and the possibility of hikes in early 2023. In the event, we agree. We have pencilled a first hike in March 2023, and another one by the end of next year, of 25bp each.

The EUR front-end is waking up to the risk of ECB hikes



Lower ECB support this year, and outright tightening next year is something that should keep fixed income market participants awake at night

This is not just something that is relevant for front-end EUR rates. Lower ECB support this year, and outright tightening next year, is something that should keep fixed income market participants awake at night. We would stop short of assigning lukewarm demand at yesterday's 30Y Italian syndication to these fears, near term political instability also deserves a mention, but we expected they played a role. Near-term, the absence of further sovereign syndication mean upward momentum in EUR yields will lose steam, but it should resume next week.

Today's events and market view

The string of December European CPI releases continues today with Germany. A slowdown in the month-on-month figure is expected, and the same is true for November Eurozone PPI.

We doubt this will do much to calm fears of central bank tightening with Martins Kazaks the latest ECB official flagging a hike in early 2023 as a possibility.

No new sovereign syndication mandate emerged yesterday so France's 10Y, 18Y, and 50Y auctions will be the only Euro government bond supply.

Jobless claims, factory orders, durable goods order, and ISM services all feature on the US economic calendar. The latter's employment component will be the final clue ahead of Friday's job report.

Mary Daly and James Bullard are the two FOMC members scheduled to make public appearances. With the Fed's tunnel vision increasingly focused on inflation, it will be interesting to see to what extent the current Covid-19 wave concerns them, if at all.

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