Rates Spark: Poking the hawks

The everything rally risks a pushback from central bank hawks. The Fed Funds path priced by the curve is at the bottom of what the Fed can endorse with current data

Fed Funds forwards at the bottom of what the Fed can endorse

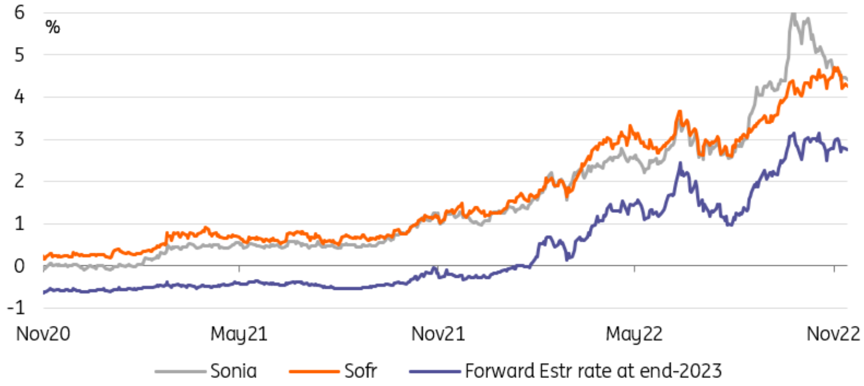
A slowdown in US consumer and producer inflation of late has pushed swap curves to price out rate hikes. This has come on the back of a related improvement in risk sentiment. However, not all that rally in risk assets has come from a perceived more dovish outlook. In theory, this should push yields higher, but it appears markets are positioned short both risk assets and safer alternatives, such as government bonds. The result is an 'everything rally' that is at risk of a continued improvement in economic data, especially in the case of bonds.

Markets are at the mercy of one upside surprise out of the next two inflation reports

The other, clearer, danger is coming from central banks. Assuming the Fed needs two more such, ideally lower, monthly CPI prints before it can consider ending its hikes, we think markets are at the mercy of one upside surprise out of the next two inflation reports. Given the volatility in the series, this is far from a scenario that we can ignore. The same goes for central bankers. The USD swap curve now prices only two more 50bp hikes in this cycle to a terminal rate between 4.75% and 5%.

This is in line with our view but we don't see Fed officials encouraging a lower terminal rate until the next batch of inflation data due in early December.

It is doubtful central banks would endorse further pricing out of hike expectations



Source: Refinitiv, ING

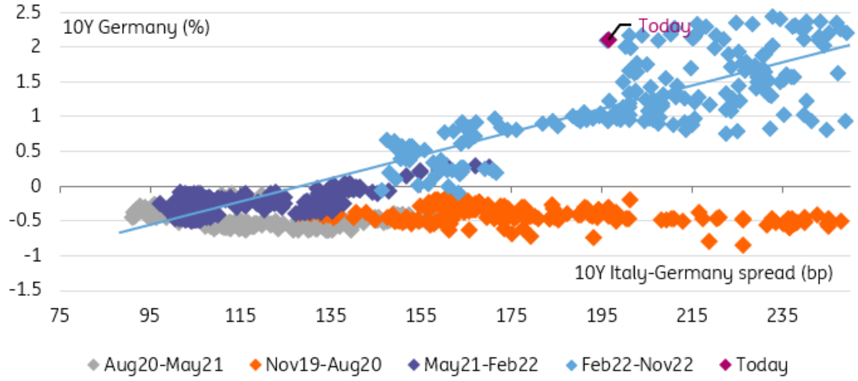
Sovereign spreads tighten in the face of QT

Peripheral bonds in Europe also joined in on the 'everything rally', benefitting from both the drop in core bond yields on hopes of less aggressive monetary tightening going forward, and more broadly on the improvement in risk sentiment among riskier assets. As a result, the tightening in 10Y Italy-Germany spreads has exceeded what its recent relationship with 10Y Bund yields levels would have suggested.

> *The ECB seems intent on reducing its balance sheet with likely detrimental effects on demand for riskier debt*

This is surely good news for a market that we identified in our 2023 outlook as one of the potential weak links as central banks continue their fight against inflation. But risks remain for higher beta fixed income, such as peripheral bonds. The ECB seems intent on reducing its balance sheet with likely detrimental effects on demand for riskier debt, especially in a recession. The hope is that an early stop to the ECB's hiking cycle, we think it could end in February, would allow markets to digest Quantitative Tightening better, but we won't know for sure until we have more tangible evidence that inflation is indeed on its way down.

The tightening in Italian spreads went beyond what the Bund rally can explain



Source: Refinitiv, ING

Today's events and market view

Eurozone data consists mostly in Italy's final October CPI print. The European Central Bank will publish its financial stability review.

The US economic calendar will be livelier with retail sales and industrial production the highlights. Other releases include mortgage applications, import and export price indices, and NAHB housing market index.

There is a long list of central bank speakers, culminating with BoE Governor Andrew Bailey and ECB President Christine Lagarde.

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