

## Rates Spark: Quantitative tightening pressure

The Fed is showing the way with aggressive quantitative tightening ambitions. With some US\$2.5tr coming off the balance sheet in the next two years, expect significant and lasting effects. Markets extrapolate their hawkish expectations to the EUR, and in light of current inflation dynamics will keep doing so, despite massive scenario uncertainty



The Fed dot plots price in two more rate hikes

### Fed heads for a 3% funds rate and a US\$2.5tr roll-off for starters

As [the US Federal Reserve is about to hit the brakes](#), the overall pattern in markets is what one would expect given the prospect of quantitative tightening.

What is noteworthy here is the near \$100bn pace of roll-off from the balance sheet per month. Again rounding, this is some \$2.5tr in the space of two years when projected. These are considerable numbers, and effectively take that volume off the Fed's balance sheet, and it then re-appears on the open market through Treasury issuance that is not taken up by Fed buying. It changes the supply dynamic on the open market, where it should slowly morph to one where

there is a lot more collateral washing around the system (and less excess liquidity).

There are two effects of this. First, it places upward pressure on market yields generally, from a pure increase in available supply effect. Second, it allows repo to clear at higher levels than we've seen in the past few quarters where some \$1.7bn gets churned back to the Fed on its reverse repo window at 30bp on a routine basis. Both of these effects result in upward pressure on market rates, both on repo and right along the curve. The move higher in market rates of late reflects this. But don't expect a quick resolution on the repo market. That will take more time.

The sell-off in especially long-end rates extended with 10Y US Treasuries around 2.60% and 10Y Bunds marching towards 0.7%, while risk assets such as equities weakened. In the eurozone this is accompanied by widening sovereign bond spreads over Bunds with 10Y Italy over Bunds now closing in on 170bp.

## ECB minutes should highlight the central banks balancing act

Yet, especially the rise in EUR rates has to be attributed in large part to the US where the sell-off has taken on a new dynamic as a sooner and more rapid Fed balance sheet reduction becomes reality. It may be the end of quantitative easing we are seeing in the eurozone, but quantitative tightening is still more distant here.

The eurozone is much more exposed to the energy supply shock, and as the conflict in the Ukraine drags on and the sanctions spiral continues to spin, the prospect of a Russian gas embargo looms large. The European Central Bank (ECB) minutes today should show a central bank performing a balancing act, on the one hand its growing desire to continue on the path of policy normalisation amid growing price pressures, while on the other being conscious of the negative impact on demand stemming from the supply shock. At the last meeting, the ECB stressed more optionality and data dependency, but on the face of it faster normalisation if circumstances allow.

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*For now inflation still takes precedence – both in market pricing and for more ECB members*

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For now it appears inflation still takes precedence and the data since then has certainly fostered the “faster” notion. Both in market pricing and in a growing number of ECB members who are now flagging a deposit facility rate possibly at zero before the year is out – after Slovenia's Bostjan Vasle it was Belgian central bank's Pierre Wunsch yesterday, though he is known to be a policy hawk.

The ECB's doves, recently Fabio Panetta and Philip Lane, continue to emphasise a more balanced view, noting that second-round effects in price dynamics have not yet been observed. And the chief economist has displayed some awareness of the tensions in European sovereign bond markets, reiterating that the ECB was ready to use its range of tools to counter fragmentation. Sovereign spreads remain one of the market vulnerabilities in our view as the ECB pursues policy normalisation.

## It's the end of ECB quantitative easing, but not quantitative tightening yet

The ECB's more detailed bi-monthly data on pandemic emergency purchase programme (PEPP) purchases – not that they are market-moving per se – do show what markets will be missing out on going ahead.

Purchases had slowed in line with ECB communication with net-PEPP purchases having declined another €10bn to €30bn in March. While the headline figure is lower, the newly released composition data covering the past two months revealed a skew in public sector purchases towards Italy and Spain over the past two months. For Italy that meant it had seen 21.5% being directed towards its government securities, which compares to a capital key implied share of just over 17% which the ECB had targeted for much of 2021.

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*Net APP purchases have been increased, but it is a less flexible tool*

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Sure, net asset purchase programme (APP) purchases increased from €20bn to €40bn per month in April to partially compensate for the end of PEPP, but keep in mind that this tool is less flexible and that the PEPP has seen between 97-100% of purchases directed towards the public sector. We remain sceptical whether managing PEPP redemption flows alone will be enough to keep spreads in check. To what degree the APP will diverge from its average of 71% since the start of 2021 in the public sector space more structurally has to be seen – a few instances of 80-90% have been observed.

### Today's events and market view

The highlight today is the release of the ECB meeting accounts. The ECB had shortened its normalisation timeline but emphasised optionality and data dependency. The forecasts backing the meeting have quickly become overtaken by events, inflation has soared but the growth outlook has deteriorated since then. Still, the accounts may hold some hints on the lift-off timing.

In supply we see longer-dated bond auctions from France including a new 15Y and a 50Y bond reopening, in total up to €11.5bn. Volatility is curbing demand for duration, but French bonds in particular have traded softer ahead of the French presidential election. Sapin is also active with bond reopenings in the 5Y to 10Y sectors and linkers.

Away from the eurozone, US initial jobless claims are the main data point for today, while we will also hear from the Fed's Jim Bullard and later in the evening from Raphael Bostic and Charles Evans.

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