Rates Spark: Raising the hawkishness bar

A hawkish pause from the Fed, but the higher dots add to its degree. Market rates have reason to rise more. The bar for the ECB to surprise to the hawkish side today and move longer rates sits high, with the market apparently well-priced already.

Federal Reserve

Source: Shutterstock

Market rates have enough here to push higher, and the front end will feel tighter even without a hike

The Fed has latched on to the theme that has dominated the market mindset in the past number of weeks, namely that the US economy continues to refuse to lie down. This has helped risk assets, as by implication default risks that would typically evolve from a recession have been kept at bay, helping credit spreads to tighten and equity markets to perform. There has also been an easing in measures of system risk, especially as immediate banking sector angst has been downsized. This overall combination has allowed market rates to ease higher, driven by higher real rates, which in turn are a sign of strength.

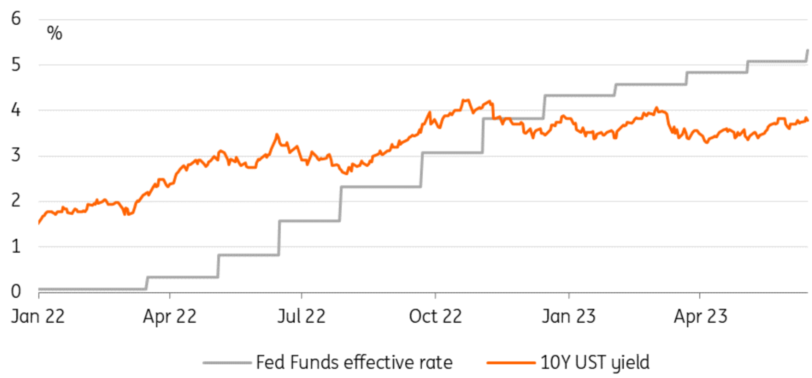
> *10yr to head to the 4% area...but still much closer to 3% by the end of the year*

Initial comments from the Fed do not negate these themes, and in fact push for more of the same. While this is more reflective of the new "dots" than anything else, it in any case pushes in the direction for higher market rates ahead. We continue to position for the 10yr to head to the 4% area, and it would not look wrong if it were to drift above for a period, at least until the illusive macro slowdown is a tad more clear-cut than now. We still expect the 10yr to be much closer to 3% by the end of the year but for now we see yields rising higher first.

There was no particular mention of the changing liquidity circumstances. Currently there is amble liquidity, with bank reserves on the rise (up from US$3trn to US$3.4trn), and still over US$2trn going back to the Fed on the reverse repo facility. The US Treasury has only slowly rebuilt its cash balance at the Fed since the debt ceiling was suspended, so the impact of less prior bills issuance and more bank support has dominated the ongoing quantitative tightening programme. Ahead, some US$500bn off liquidity will get drained out of the system as the Treasury rebuilds its balance through net bills issuance. We expect from that a combination of lower bank reserves and lower cash on the reverse repo facility.

This will make it feel like there has been some tightening in conditions, even if not in levels (as the Fed has not hiked).

Still hawkish, but harder to regain traction further out



Source: Refinitiv, ING

The bar for a hawkish surprise from the ECB sits high

An ECB hike is widely anticipated and all but one of 39 economists surveyed by Bloomberg ahead of the meeting see an increase of 25bp today. If that is the outcome, this means that if the ECB wants to land a hawkish message, it has to do so via its communication on where it sees policies heading further after today.

> *Market pricing already looks well aligned with broader the ECB communication*

Markets are pricing another full hike by September with small chances for even having seen a third hike by then. On the face of it, market pricing already looks well aligned with broader the ECB communication ahead of the pre-meeting quiet period that started last Thursday.

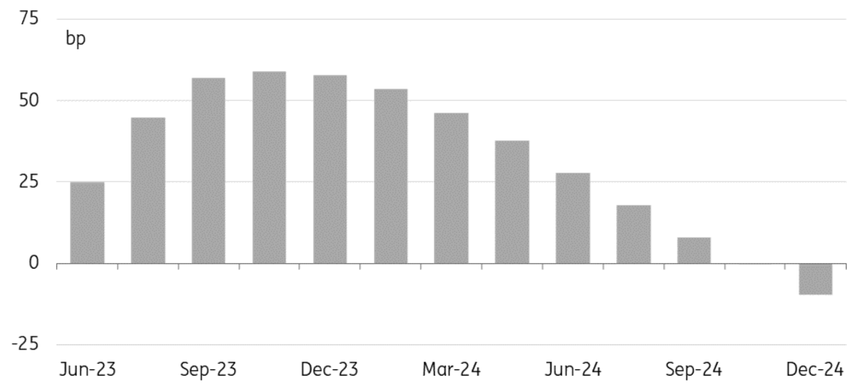
Leaving the door open to more is one thing, but markets will also scrutinize the new staff projections available this time. Our economists hardly expect any revisions to the inflation forecast, i.e. 2025 headline and core will remain at 2.1% and 2.2% respectively, but growth forecasts will probably have to be revised downward to some extent given the disappointing macro readings of late.

This also highlights why there have been growing doubts also about the ECB's ability to push market rates materially higher from here. Sure, there are almost 70bp in cuts priced from the peak rate through the end of 2024 which could fall victim to a "higher for longer" narrative gaining more traction. But longer rates such as the 10Y will probably reluctant to move above recent peaks as they have to account also for an increasing probability of the ECB falling behind the curve and, in hindsight, committing a policy error. In short, we think a bear-flattening bias in curves could prevail for now.

The ECB has aleady set excess reserves in the banking system on a clear downward trajectory

The ECB balance sheet will receive more scrutiny. Not only has the ECB already said at the May meeting that it expects all APP reinvestment to end in July, but at the and of this month a €477bn TLTRO will come due. It is not seen likely that the ECB will announce any new operations, but the ECB has set excess reserves in the banking system on a clear downward trajectory with its decisions. There could be questions of how far the ECB is willing to take this also in context of the ongoing policy framework review that is slated to be completed by the end of this year.

Market expectations of ECB rates through 2024



Source: Refinitiv, ING

Today's events and market view

The larger than expected increase in the Fed's own rates projection, left longer rates little impressed with 10Y UST yields ending the US session little changed just below 3.8%. Front end rates edged higher though higher resulting in the 2s10s briefly dipping 10bp before going out at -90bp, the most inverted since the March banking turmoil.

Central banks hawkishness seems to be loosing traction, and this is also the risk for the ECB going into its press conference today. If President Lagarde manages to live up to hawkish expectations, though, then a bear flatting should be the outcome.

But markets attention could quickly shift back to what drives it all - the data. The US PPI yesterday provided more hints of easing pipeline price pressures. The same may hold for the import prices released today. The weekly jobless claims numbers will also receive more scrutiny give last weeks larger uptick. Also on the slate are US retail sales.

In primary markets France is selling short to medium term- as well as inflation linked bonds today for a total of up to €13.5bn. Spain sells bonds out to 15 years for up to €5.5bn.

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