

Rates Spark: Rates pressure intensifies

A hawkish hike from the Fed. The 5% handle is the big one for the markets to reconsider ahead. The entire curve is well under this. Something must give, with likely some upwards pressure on market rates for starters. ECB and BoE hawkishness today may have more impact, given lower conviction surrounding peak inflation.

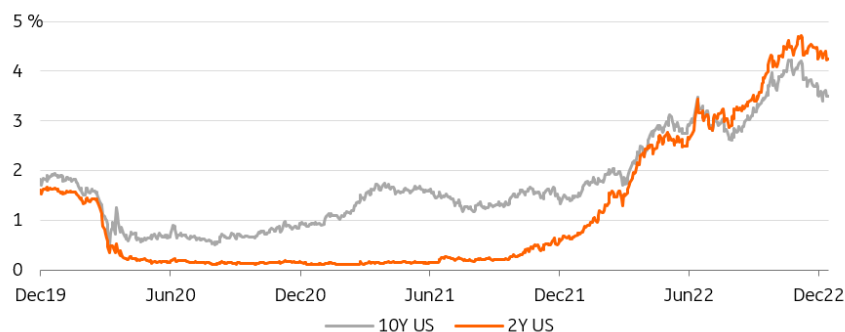


Market rates under pressure to back off now and test higher in the months ahead

Markets need to re-think the sustainability of the bond rally seen in the past month. Nominal and real rates are seen up. But not by very much. With no sense as of yet that the Fed is done, we continue to call for market rates to move higher from here. We likely have seen the highs at 4.25%, although our models in fact call for a peak with a 5% handle, and the anomaly here is how big the discount is between the 10yr yield and the likely peak in the funds rate.

The 50bp fall in the US 2yr yield between this FOMC and the previous one correlated with a steady ratchet lower in the market discount for the terminal Fed funds rate. At the peak, the market was discounting 5-5.25%. It's now discounting 4.5-4.75% as a terminal range. This also ratchets lower the upward pressure on the 10yr yield, which tends to be influenced by where the funds rate peaks. It still leaves us with a conundrum where the current 10yr yield looks quite low relative to a terminal funds rate set to be a bit hit in mid-to-late-Q1 of 2023. If the 10yr stays here, the discount would be in excess of 100bp, which is quite large relative to the past few decades. We think the 10yr can narrow that discount in the coming month or so.

2Y and 10Y Treasuries yields have peaked well below the Fed's signaled terminal rate of 5%



Source: Refinitiv, ING

And no change in balance sheet policy

Chair Powell had little to say of any materiality on the bond buying unwind. There had been a small probability attached to the possibility that the Fed could have considered outright bond selling (as opposed to the less impactful ongoing bond roll-off). The rationale could have been to mute, or even reverse, the significant fall in long end yields seen in the past month; done with a view to re-tightening financial conditions. In the event, the committee is not looking into this just yet. It remains an option, however, especially should the Fed require an overall tightening in liquidity circumstances to push in the same direction as the higher rates policy does.

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The Fed also remains relaxed with the ongoing volumes going back to them on their reverse repo facility. Recently this has ticked back up again towards the US\$ 2.2trn area, partly as the US Treasury curbs bills issuance in an effort to smooth the rise into potentially hitting the debt ceiling by mid-2023. That aside, the bond roll-off programme has done more than cause the volume of cash going back to the Fed to plateau. The repo market would like to see this fall. From the Fed's perspective this is a facility that's doing its job; mopping up liquidity at 5bp above the funds rate floor. So, no change in the Fed's tune on this. 2023 should see these volumes ultimately wind lower, albeit slowly over the course of the year.

As for today's session, the focus will shift to the ECB and BoE policy decisions. Both may be seen moving closer to the end of their respective hiking cycles, but the data backdrop provides for less conviction that the central banks have gained the upper hand over inflation just yet. That leaves still more tightening to do and less to discount in terms of subsequent cutting cycles.

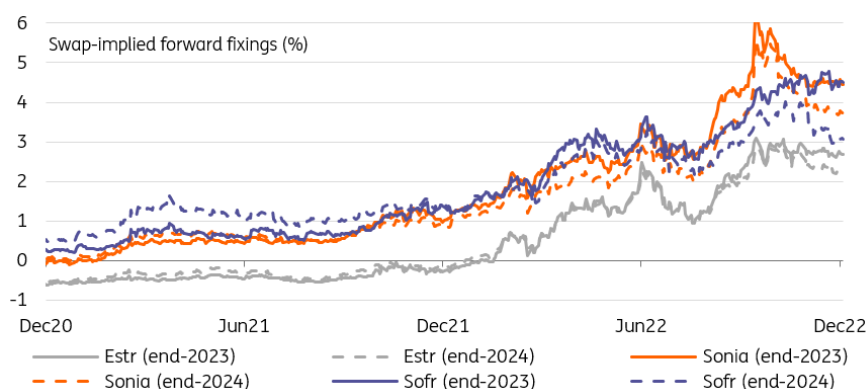
ECB: Key QT principles and still risk of 75bp

- **Interest rates:** A 50bp hike is our base case, and also the markets', with the forward discounting 53bp. However, we think that the risk of a larger 75bp has increased of late.

Probably only afterwards will we learn of any reluctance within the Council to shift to a slower pace.

- **New forecasts and outlook:** A slower pace of rate increases will likely be offset by a strongly worded warning that the fight against inflation is not over. The ECB may well project inflation falling back towards its 2% target only in 2025, and keep in mind that some officials have become more sceptical of forecasts in the current unprecedented times. We do not anticipate the ECB to stress downside risks to growth more than before, as this would dampen any hawkish impetus from the meeting that the Council likely still desires, given how financial conditions have evolved.
- **Quantitative tightening:** The ECB has said it would announce the “key principles” of reducing the ECB’s APP portfolio at today’s meeting. “Measured”, “gradual”, and “predictable” have been the adjectives commonly used by officials, which suggests a phased-in approach to QT, using caps initially. A hawkish twist would be to simply let the portfolio run off, as Bundesbank’s Nagel has suggested, with a view to the resilience of bond spreads this far. The ECB could also already hint at a start date to underscore its hawkishness. The consensus is already eyeing a beginning of QT at the end of Q1 or early Q2 2023.

Swap curves are increasingly pricing rate cuts in 2024



Source: Refinitiv, ING

BoE: Shifting to back to 50bp

- **Interest rates:** We expect a 50bp hike and forwards discount slightly more than 53bp, suggesting only a small chance for a larger 75bp hike.
- **MPC voting split:** More relevant this time around for judging the “dovishness” of the hike will be how the MPC has split its votes. A three way split is likely according to our economist, so we will be looking for either a low number of votes for higher 75bp, or more than the likely two votes again from the known doves for a smaller move in the case of a dovish hike.
- **Press statement:** We will not get new forecasts nor press conference this time around, merely the press statement and the minutes. Data since the last meeting has been stronger, with wages rising near a record pace. While headline inflation has eased, the more relevant core services inflation has been higher than what the Bank anticipated in November. On the other end, the Sterling recovery will have alleviated currency concerns of the MPC hawks. All in all we think it likely that the Bank will stick to its current guidance of being able to act forcefully if necessary. Another comment directed at market pricing being too high does not look warranted, given it has already eased back.

Today's events and market view

As noted before, hawkish surprises from the central banks this side of the Atlantic have greater chance of proving market-moving and lasting given that it is less clear here that inflation has seen its peak yet. In EUR rates the impact of upcoming supply surge as announced by the German debt agency yesterday could be compounded by the ECB's quantitative tightening taking on more of a concrete shape.

In data we will get US retail sales as well as initial jobless claims as highlights. Also on the cards are the Empire Manufacturing survey and Philadelphia Fed index.

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