Rates Spark: riding the perfect storm

Despite a calm reaction to the Fed, bond yield upside is resuming quickly - with a surprise hike from the Swiss National Bank, hawkish Bank of England interpretations, and an ECB fragmentation tool potentially swapping spread widening for yield upside.

Source: Shutterstock

The Fed is in line with the market but rate upside still dominates

For once, it isn't the Fed's stance that is keeping bond investors up at night. Granted, the pace of hikes has accelerated from 25bp in March, to 50bp in May, to 75bp in June...but the Fed has managed to forewarn investors, resulting in tame price action around the meeting. Powell did not exclude a further 75bp hike but was quick to signal that this isn't the new default increment. The Fed and financial markets now seem more aligned both on the path for rates and on economic prospects. Even if this means greater risk of recession, it looks like markets took heart from the central bank being on the same page as them.

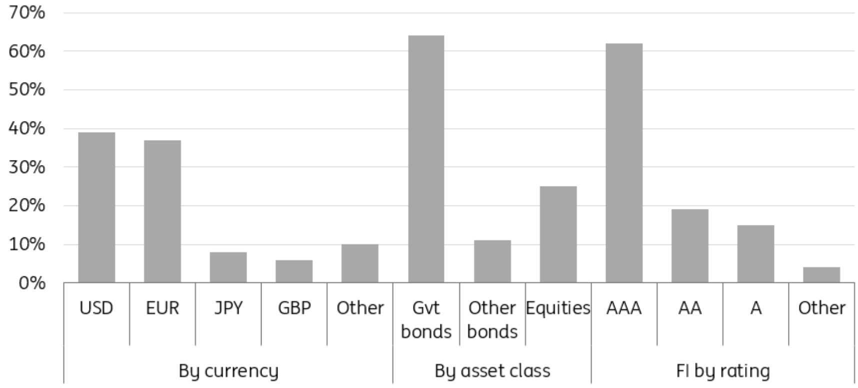
10Y Treasuries now have 3.5% firmly in their sights

This doesn't mean rate upside has reduced however. For one thing, the Fed has just shown that its policy path will react to inflation prints and there is no guarantee that the string of upside surprises will stop. 10Y Treasuries now have 3.5% firmly in their sights even if they might wait for the next inflation release to test that level. What's more, other central banks are not as advanced in their tightening process and the risk of hawkish surprises from various parts of the world means yield will rise further still.

Hawkish surprises keep on coming

The most recent example is the surprise 50bp hike from the Swiss National Bank (SNB), against a consensus for no hike. Not only does the move forces markets to rethink the central bank's reaction function, it adds to the case for more aggressive action in other jurisdictions. Worst still, from the point of view of bondholders, the risk of FX intervention to defend the CHF means the SNB may soon sell out of its portfolio of foreign bonds. We think EUR bonds are most at risk on account of their lower liquidity compared to US peers. We have also identified the semi core sector (eg France) as being particularly vulnerable.

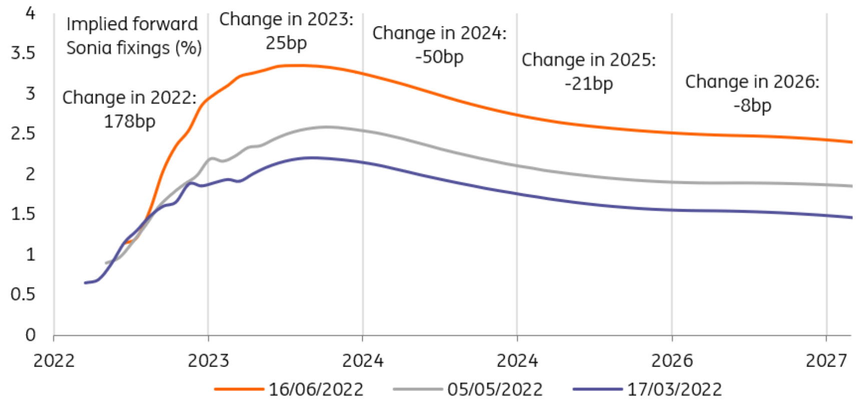
SNB FX sales would put USD and EUR bonds at risk (FX reserves at end Q1 2022)



Source: SNB, ING

At face value, the Bank of England bucked the hawkish trend at its June meeting by hiking by 'only' 25bp. But the accompanying statement was more hawkish, in effect opening the door to more aggressive tightening if necessary, and enough for markets to conclude that an acceleration is in the cards. At this stage, we think this rests on an assumption about future data that we are unprepared to make, but at least the sell off in gilts after the meeting is consistent with the way markets anticipate future policy more in other countries.

From its recent communication, markets are looking for an even steeper path for BoE rates

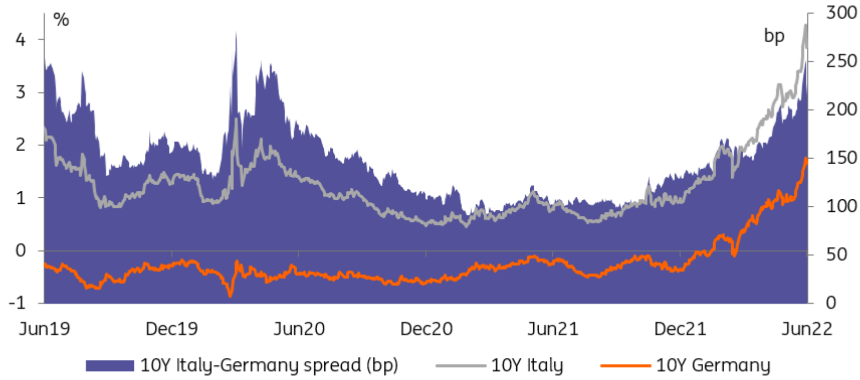


Source: Refinitiv, ING

ECB spread management could add to yield upside

If this wasn't enough to keep bond investors on their toes, public comments about [the ECB's fragmentation instrument] are coming thick and fast. The most detailed (anonymous) indication so far has come via a Bloomberg source, suggesting that the facility would sell core bonds to neutralise the effect on inflation from purchases of Italian bonds. In our view, this is a key limitation on the size of the ECB intervention as adding bond sales in one of the worst bond market sell off in recent years poses financial stability risks. This may only be one of the many potential designs under consideration but we think this constraint would diminish the facility's efficacy, making it more likely that the ECB has to buy peripheral bonds, and so result in more purchases that necessary.

The ECB fragmentation tool could be swapping wider spreads for higher yields



Source: Refinitiv, ING

A range of opinions exist about what ECB intervention would look *like*

There also seems to be competing visions of what that instrument would look like. Recent public comments have shown that a range of opinions exist about what ECB intervention would look like. For instance, Muller seems to favour a light touch approach while Visco went as far as giving a levels in the 10Y Italy-Bund spread that is warranted by fundamentals, and so as a potential target. The reality of the new instrument is likely to land somewhere in between these view but they serve to illustrate, alongside the potential constraints floated in the press, why the ECB was reluctant to launch this tool.

Today's events and market view

In our view, this week has shown that central banks are very much on their front foot when it comes to tightening policy in the face of higher inflation, and markets have no reason to think this will stop any time soon.

This morning's update to the Eurozone headline and core CPIs is a final reading and thus less likely to catch the market off guard. The same cannot be said of US manufacturing and industrial production.

Central bankers won't venture far from centre stage with Fed chair Powell due to speak in the morning, and with Silvana Tenreyro and Huw Pill of the BoE both making public appearances.

The ECB will announce the amount of TLTRO funds banks will repay this quarter. Our financial analyst team thinks a modest €150bn will be repaid as the interest rates incentive for keeping funds grows as ECB rates increase.

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