Rates Spark: Spice it up, please

If there is a hawkish signal sent by the BoE today, we think it will relate to its balance sheet unwind strategy. We see no need to signal hikes given the existing curve discount; a steeper curve is on the cards. Meanwhile, US yields continue to play games with the data and are minded to test lower in yield regardless, trading as if there has been a macro collapse.

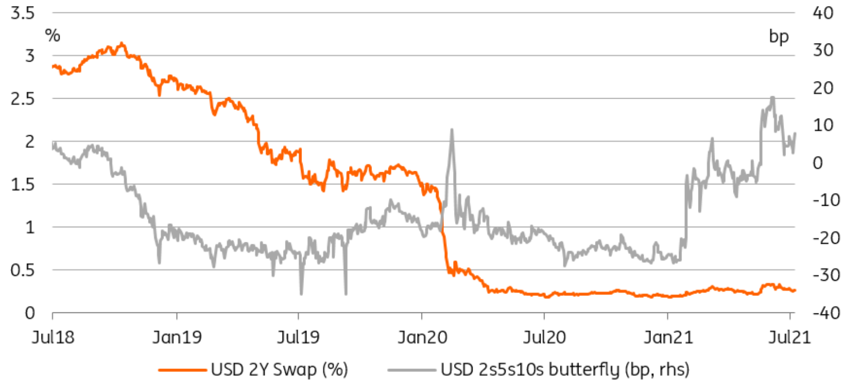
Bank of England Governor Andrew Bailey

Source: Shutterstock

The Fed vice chair nods approval for tightening, but not dramatically deviant from the central party line

An initial flurry of consternation surrounding comments made by Fed vice chair Clarida yesterday soon faded thereafter, and for good reason. Although Clarida indeed is a centrist, and not expected to veer too much from the party line, in fact there was very little such deviation. There was no material deviation from the median dot that has already been planted in 2023, and talk of tapering by year end is perfectly in line with market thinking of where the Fed's head is at. The notion that the Fed will have made the required substantial progress by year end is also fitting with this, and especially following the messaging that came from the end-July FOMC meeting. The 2yr ended up 1bp higher, and the back end ultimately did not care.

The USD curve and short-end date shrugged off Clarida's comments



Source: Refinitiv, ING

if the 10yr is on a slide it's tough to argue that raising front end rates would be the logical thing to do

What was interesting from Clarida was acceptance of surprise that long rates have fallen by so much. This must be a hot discussion point for the Federal Reserve. While a rate hike from the Fed remains some way off, if the10yr is on a slide like we've seen in recent months and trekking towards 1% it's tough to argue that raising front end rates would be the logical thing to do. Really for the Fed to come in and comfortably engineer a series of rate hikes, the 10yr should be much closer to 2%, and ideally with a very comfortable 2 handle. We could still get there. An accelerated tapering would help, but we did not get enough from Clarida to suggest that was on the main menu, at least not yet. Expect more on this super-hot topic ahead.

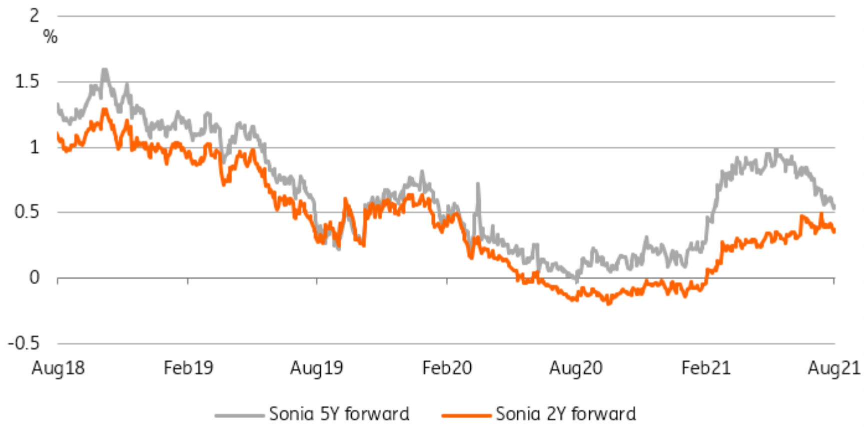
The bond market has been behaving as if there has been a macro collapse in recent months

Data? Who cares, it seems. The bond market doesn't. Reasonably uppity survey evidence from both the manufacturing and services sectors this week so far has been ignored. US payrolls could be too. The ADP was weak, and that's the risk for payrolls on Friday. But the bond market has been behaving as if there has been a macro collapse in recent months anyway. We need indeed to see the number, but we'd argue that even if we knew the number now it's hard to know which way yields will go, apart from down.

BoE looking for the signs

By and large, our economics team expects the Bank of England (BoE) to refrain from sending policy signals at its August meeting, but this doesn't mean today will be a quiet session for sterling markets. Context matters. In the run up to the meeting, two MPC members spoke in favour of an earlier withdrawal of accommodative measures. As a result, we wouldn't be surprised to see some members (a maximum of two), voting in favour of stopping QE earlier than the planned end in December 2021. We doubt the idea will gain in popularity among other members given that the programme is already near its end and due to the communication challenges this will cause.

The curve is pricing more than one hike within 2Y but is not convinced the BoE will go much further

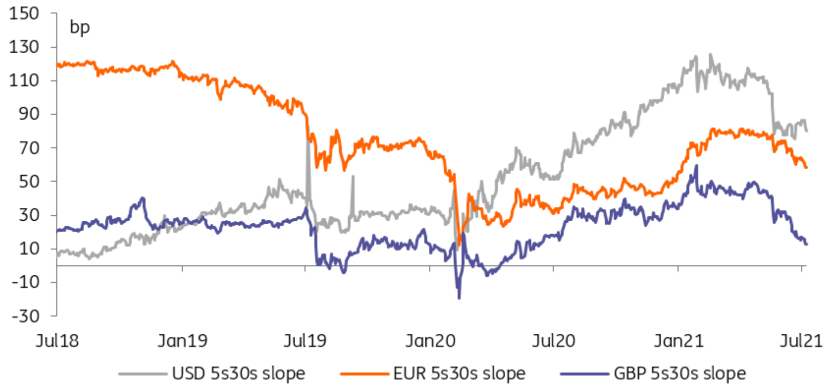


Source: Refinitiv, ING

As inflation risk is getting more airplay, calls for an earlier hike are getting louder

One reason why the BoE doesn't need any additional communication challenges is that there is already an intense debate happening about the timing of the first rate hike. We think early 2023 is the most likely timeframe but an earlier move in late 2022 is conceivable. As inflation risk is getting more airplay, calls for an earlier hike are getting louder. With the swap curve is already pricing a hike next year, we see no need for the MPC to send a signal on that front.

This flat, the GBP curve is priced for the hawkish policy mistake



Source: Refinitiv, ING

The GBP swap curve is way too flat

A third topic of interest, as its tightening cycle is getting nearer, is how the BoE will go about managing rate hikes and balance sheet reaction. Governor Andrew Bailey has spoken in favour of both running in parallel, which would be a departure from the sequencing envisioned in the last cycle. There is no certainty that the BoE will address the issue today, but such a momentous decision needs to be communicated well in advance, in our view, so it makes sense to prime the market for it. We think the GBP swap curve is way too flat for this possibility.

Today's events and market view

A number of 'tier two' releases in the European morning but we doubt these have much market-moving potential. Instead the attention will be on Spain and France selling bonds in relatively illiquid markets, and thus putting upward pressure on yields in the first half of the day.

The main event of the day is the BoE meeting (see above). This meeting will feature an update to its quarterly monetary policy report and a speech from Governor Andrew Bailey. The absence of a hike signal and possible clues on balance sheet reduction would put steepening pressure on the curve.

The afternoon will only offer a weekly jobless claims update but Fed governor Christopher Waller will add his voice to the chorus of hawkish Fed officials who have spoken recently.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

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