Rates Spark: The burning question

The Fed appears like a beacon of stability compared with other central banks. It has set a clear timeline for its tightening. As long as the market believes that timeline, rates should continue to converge higher. Volatility is expected to remain elevated, but this will not necessarily spread to other markets

Federal Reserve building in Washington, DC

High volatility but this could be worse

Market gyrations this week should serve as an illustration that recent spikes of volatility, were not isolated events but a sign that rates markets have entered a more volatile phase. This fact itself warrants its own conclusion. In a market where realised volatility is on the rise, it is only natural for investors to question the size of their exposure to low yielding products. The reasoning is as follows: for an asset to be valued fairly, risk must be compensated by higher returns. In the case of low yielding government debt, if there is a sustained increase in volatility, then investors would supposedly only be willing to buy it for higher yields.

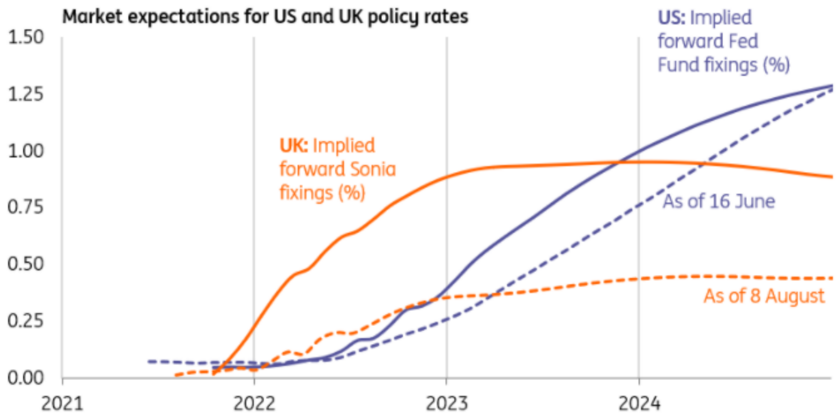
The burning question is: how long will central banks shield markets from volatility

This theory can often be put to the test by central bank intervention, primarily bond purchases skewing lower the 'compensation' offered for investors to take on an asset's risk. The burning question is: how long will central banks shield markets from the volatility that should normally occur when the range of possible economic outcomes is as wide as it is currently? Judging from the Bank of England's urgency in signalling a policy tightening in the face of inflation fears, the answer seems to be 'not a lot longer'.

All eyes on the Fed

Indeed, there are differences from one country to the next, but inflation fear is a global phenomenon and the action of one central bank can precipitate that of another. Typically, it is the largest of them, the Fed, forcing the others' hand, although it could be said that the European Central Bank and Bank of Japan actions have also had a noticeable effect on rates markets globally. In any case, the Fed currently looks like a beacon of stability with its tapering timeline running until mid-2022, acting as a dam against the market pricing hikes before the latter half of 2022.

The Fed's tightening timeline (as of Monday) is reassuring markets, so long as they believe it



Source: Refinitiv, ING

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Much then, depends on whether the market comes to doubt the Fed's guidance. If it does, then the current phase of higher volatility can continue in rates but does not have to spill over to other markets. Calm in risk assets also means that government bonds fail to benefit from much of a safe haven bid, and their yields continue to climb higher in line with the progressing recovery. If, on the other hand, doubts spread about the Fed's ability to manage a smooth exit from exceptional level of accommodation, then risk sentiment could deteriorate rapidly, and we would be back to square one.

Today's events and market view

Today's calendar is skewed towards US releases with jobless claims, Philly Fed, and existing home sales all due to be published. After that batch of US data, there will also be advanced October Eurozone consumer confidence release to look out for. Consensus here is for a decline, in line with a drop in confidence surveys across the Eurozone.

There will be more bond supply for the market to digest, from Spain (6Y/16Y) and France (4-5Y, and linkers), but the duration will not be as significant as yesterday's Italian sale. This should allow the long end a much needed respite, although we think a good chunk of the post-supply relief rally in long-end EUR bonds has already occurred yesterday afternoon.

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