Rates Spark: The Fed does see what we see

We had highlighted three risks to our base case, and the Fed managed to deliver on all three. The market reaction has been clear, but actually muted - ahead is key. The ECB allots the 8th TLTRO-III. Immediate impact is likely marginal, but the future of the programme creates some uncertainty that we think is reflected in the wider forward money market spreads

Source: Shutterstock

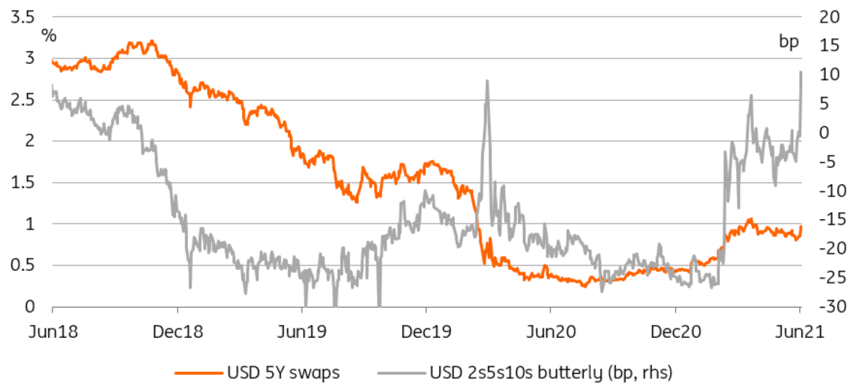
A technical move from the FOMC, but still the effect and marginal direction of policy is clear

The shuffle of dots into 2023 (and 2022) from 2024 marked acknowledgement that the macro data had moved the needle at the Federal Reserve, which was also reflected in upward revisions to inflation forecasts, and verbal acknowledgement of the same. And there was the little matter of delivery of a rate hike. Just 5bp, and a technical move. Not an attention-grabbing tightening in policy but still, in the end, a hike.

The 5bp hike in the rate on excess reserves (from 10bp to 15bp) is a technical move

The 5bp hike in the rate on excess reserves (from 10bp to 15bp) is being downplayed by the Fed as being just that, a technical move. In fairness, it is just that. At the same time, it is certainly not a loosening in policy, and in fact fits with a series of moves of late that have been of a tightening ilk. Remember that, in recent months, the Fed decided not to extend the leeway granted to banks in the treatment of reserves and bonds on their leverage ratios. That was a tightening. The decision to sell its (small) corporate bonds portfolio is also a tightening. The 5bp hike today is in a similar vein of a gradual chipping away at stimulus. A technical move, but all of this is pointing in the same direction.

5Y cheapened on the curve, a sure sign hikes are back in focus



Source: Refinitiv, ING

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The Fed also hiked the rate at its reverse repo window by 5bp (from zero to 5bp). This, together with the 5bp hike in the IOER, is designed to coax up rates on the front end of the curve. This has been a policy choice that could have been executed for a number of months now, but became more front and centre given the large flight of cash back to the Fed at this window in recent weeks. The hike in the rate itself is not going to be a trigger for a lower use of this facility. But the combination of this elevation plus the one of excess reserves changes the dynamic on the ultra-front end. It should directly push up the SOFR rate (likely also by 5bp; market driven), and will impact higher alternatives in this space ranging all the way into the bills market.

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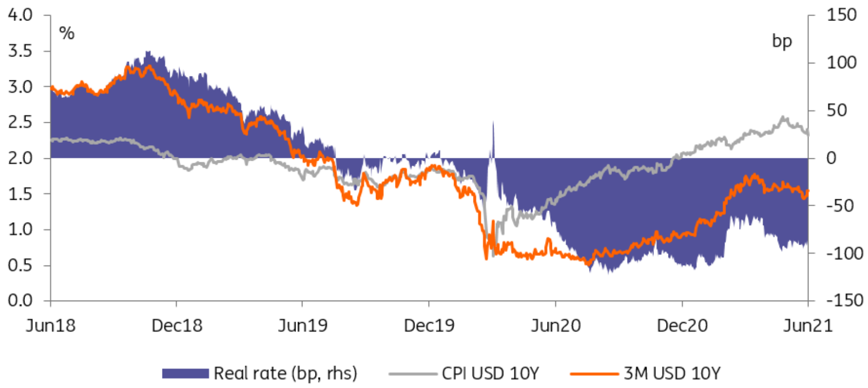
20bp.

Market rates are higher generally in consequence. The 10yr is back up towards 1.55% and the 2yr is approaching 20bp. That's the highest for the 2yr in about a year, which makes sense as it is now sniffing out a rate hike before it matures. And there's been an even bigger move on the 5yr, as the 5yr underperforms on the curve (still a tad rich to the curve, but more neutral now than it was). This is a classic bearish reaction and one that can act as a momentum change as the market begins to pivot towards rate-hike preparedness, from a point of neglect of that as an imminent risk.

US nominal and inflation rates have converged somewhat, but real rates are still deeply negative



Source: Refinitiv, ING

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A big move has been seen in real yields too, practically a 10bp gap higher, and forcing inflation expectations down (a tad). Still deeply negative (at c.-80bp in the 10yr), but moving higher again. This is important too. If the recovery higher in rates is to have legs, it should ideally come from less negative real yields. The fall in inflation expectations also tells us the market place is pricing in a better protection from the Fed. Not much, but certainly more than was in evidence before the FOMC meeting outcome.

The ECB allots the 8th TLTRO tranche

Money markets could receive more attention today with the ECB announcing the allotment of the 8th installment of its targeted long term refinancing operation (TLTRO-III) offered to banks. It provides 3Y funding to banks at a preferential rate of as low as -1% for the first year if certain lending targets are met. Two more quarterly tranches will be offered later this year.

Banks should already be closer to the borrowing limits that the ECB has imposed

Banks have so far drawn more than €2tn in total via the TLTRO-IIIs. Part of their charm is that given the negative interest charged banks can offset the penalty incurred on their excess reserves that they park at the central bank at -0.5% currently. However, banks should already be closer to the borrowing limits that the ECB has imposed meaning that the take down this time could be considerably lower than the €331bn observed in March.

While the TLTROs have been a main driver of spread compression in money markets, we doubt that the upcoming tranche will have much of an impact. At an overall level of excess liquidity of already above €4tn, the additional impact is likely to be marginal. What could be more important is any indication of what happens once the preferential interest period ends in June 2022. Will it trigger repayments and lower liquidity once it ends?

We doubt that the upcoming tranche will have much of an impact

Whether that will be allowed to happen remains the question, given the TLTROs' role in offsetting the negative depo penalty on excess reserves created via QE that some ECB officials have previously highlighted. Of course the ECB also has the "tiering multiplier" that it can still adjust to allow banks to park more at the central bank. Still, there is some scenario uncertainty and we think this also plays into money market forwards pricing a widening of the 3m Euribor OIS from currently below -6bp to -3bp in one year's time.

Today's events and market view

There is little in terms of data releases today apart from the usual weekly initial jobless claims data in the US. In EUR the focus will be on the ECB's allotment of the 8th TLTRO tranche at 11:30 am CET. The previous tranche had been met with good demand from banks which took down €331bn. This time around a figure could be significantly smaller as banks should be closer to their borrowing limits.

EUR government bond supply activities continue, with France reopening bond in the 4Y to 8Y maturity range as well as inflation linked bonds, overall to the tune of up to €12.25bn. Spain reopens 3Y to 16Y bonds for up to €6bn.

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