Rates Spark: The Fed wouldn't dare, would they?

No rate or QE change likely from the Fed - that's the easy bit. But, will they hike the rate on excess reserves? Not expected (but they actually should). Will they extend the SLR break for US banks? They likely will (but probably shouldn't). Will the dot plot move? Likely not much. Will the terminal rate rise? Likely not. But then again, they might not not ...

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FOMC preview

With the broad brush of Fed policy in a holding pattern for the fed funds rate and the volumes of QE being done, the Fed might just get a bit more technical than usual this time around. Two key items here.

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First, they may well have something to say on the emergency adjustment made to the supplementary leverage ratio when Covid broke about a year ago. Back then, the Fed decided to allow US banks to exclude holdings of Treasuries and deposits at the Fed from it, but for a temporary period that is due to end on 31 March 2021. We think they will extend it, and if so, there is nothing to see here. But, if the Fed were to choose not to extend, then there could be repercussions. One could be selling of US bank holdings of Treasuries; we calculate that they currently hold an excess of some $600bn. Another could be that banks choose to take fewer deposits. We think this is less likely, despite the tough talk in some quarters, but the Fed could choose to avert this discussion by just extending for deposits, and not for Treasuries. To be seen.

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Second, the Fed will be aware that the Secured Overnight Financing Rate (SOFR) has been peppering the 1bp to 2bp area in recent weeks. The SOFR rate is not a Fed policy rate, but still, if it were to hit zero (or worse, dip negative, even if unlikely with the Fed there with a zero repo rate) it would be a tad inconvenient. It could suggest that the Fed has lost some control over the front end, as a key rate hits zero while the economy kicks through the gears. But also, SOFR is an important rate to say the least, as it is the favoured rate for use on transition from Libor. In fact, there is official sector pressure in place on players to make that switch sooner rather than later. If SOFR were to go negative, even if briefly, it could cause some to pause for thought. What to do? Provision of more collateral through issuance is one solution. Another is to hike the rate on excess reserves (IOER), just to act as a pull upward on other front end homes for liquidity.

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And by the way, these issues are linked. By keeping US banks heavily invested in the excess reserves bucket, by extension the effect of an IOER hike, even if just by 5bp (but we think it could be as high as 10bp), would be magnified. That is an advantage to extending the exclusion of deposits at the Fed from the supplementary leverage ratio. The link with Treasuries is also there. The Fed will be happy with the rise in US market rates to date, as it implies a growing market discount that a reflation outcome is dominating the prior deflationary one. But the Fed will also not want to add fuel to this from a technical sense by making an adjustment that provides the bond market with an excuse to potentially overshoot versus fundamentals.

Surprise could come from the median dot hike switching from

2024 to 2023 and/or an upward adjustment to the terminal rate from 2.5%. Neither are expected, but we still need confirmation for comfort

There are another two key items to take into account. First, the degree to which some of the dots (from the dot plot) that currently sit in 2024 move to 2023, and whether there will be enough movement there to move the pendulum to 2023 for a first hike. If it did, that would be big, and would go down as unexpected. Second, the level of the terminal rate is important. The median dot plot currently pitches it at 2.5%. In all probability it stays there, but if it moves at all it would be higher. A surprise here is less likely, but if there were one, it could put some fuel under the long bond yield, now at 2.4%. Again, less likely that we see a move here. But if there were one it would have impactful implications, as it telegraphs not just the level of rates in the long term, but also a whole narrative that surrounds that.

Today's events and market view

With the FOMC meeting looming large as potential catalyst for the next move in Treasuries, EUR markets are unlikely to venture far with data calendars otherwise void. Still, Bund yields have started testing the downside again of late. ECB buying is one driving factor, the delays in the vaccine rollout and bad news surrounding the AstraZeneca vaccine the other factor that have capped yields recently. The European Medicines Agency (EMA) has announced that experts would reach a conclusion on the matter on Thursday.

As markets digested the sale of a new €7bn 23Y green OAT yesterday some of the earlier gains were pared. In particular the EUR 10s30s curve which initially flattened in unison with declining outright levels, proved stickier once the 40bp level was reached. The curve may well continue to feel pressure from the issuance pipeline ahead. Germany taps the 30Y sector today for €1.5bn. The next EU SURE deal also looms large, though likely only next week's business. Other issuers have also been drawn back into the market with the ECB having ramped up PEPP resulting in more benign market conditions: Yesterday Greece announced a 30Y bond and Luxembourg a new 10Y benchmark, both likely today's business.

As to the FOMC meeting itself, the market will likely be watching the policy sensitive belly of the curve, with the Fed's dots providing the music.

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