Rates Spark: The market push on the ECB and Fed

The European Central Bank is under market pressure to hike by more than they'd like while the Fed should look at market forces as a rationale not to over hike next week. Right now the ECB needs to get cracking while the Fed can wind down (after July), which is more reason for the ECB to take the opportunity to get rates clear of negative territory while its there

ECB under market pressure to do more

Our preliminary call for a 25bp hike from the ECB reflected what we thought they would do, not what we thought they should do. What they should do is 50bp. Why mess around with a 25bp hike that pitches the deposit rate then at -25bp only to wait for a next opportunity in September to deliver another hike to take it out of negative territory. Better to do 50bp and take it out of negative territory in one go. A 25bp, frustratingly, was always likely to be the ECB way. But that seems to have changed in the past 24 hours. It seems that the ECB could be on the verge of a 50bp hike.

Market expectations have been consistently more upbeat on what the ECB could be doing. For a long time we thought them overdone, not because they were silly, but because that is not the way this ECB is likely to behave. Markets can argue that there are many good reaons to go the full 50bp. Here are a few: 1. Even if it does not solve the inflation issue, it at least pushes against it, 2. It gets rates out of negative territory, which is not a natural state in the first place, and 3. It shores up the EUR, which remains under big pressure to the downside. The counter is financial conditions have deteriorated, but at the same time if the ECB does not get up and running it risks losing the window completely.

Fed under market pressure not to overreact

It took some time for the Fed to move, but its been up and running for a number of months now. A 9% handle on the latest inflation reading caused some to call for a 100bp hike from the Fed next week. We argued against that. The biggest reason? Inflation expectations have fallen. In fact they have fallen significantly. The 2yr breakeven fell from 4.5% about a month ago to around 3% currently. This in fact looks too low, as to average at 3% underlying inflation needs to get below that, and from a starting point in the 6% area.

Chair Powell rationalised a 75bp hike at the June meeting as he saw inflation expectations on the rise (which is in fact questionable). But right now inflation expectations have calmed considerably. Also the the curve structure has morphed from one discounting higher market rates to one that is not, as the 5yr area has moved from a point where it traded cheap to the curve to one where it it now neutral. Should the Fed deliver another 75bp next week, then the 5yr should start to trade rich to the curve, and should continue to richen.

> In fact the next big move on the US curve looks set to be a big front-end-led steepening process. We are not there yet as the Fed is not quite done yet. But that would be a point from which it could be quite difficult for the ECB to hike by much. So, we would argue, best to get as much done now (and in the next few months) as possible.

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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