Rates Spark: The rally is starting to look stretched

The loosening in financial conditions is not going unnoticed with central banks. Their pushback is becoming more vocal. Next week's events will be a crucial test for the sustainability of the rally in rates, which looks to have its roots not just in markets' fundamental reassements but is also seeing technical factors at play

Source: Shutterstock

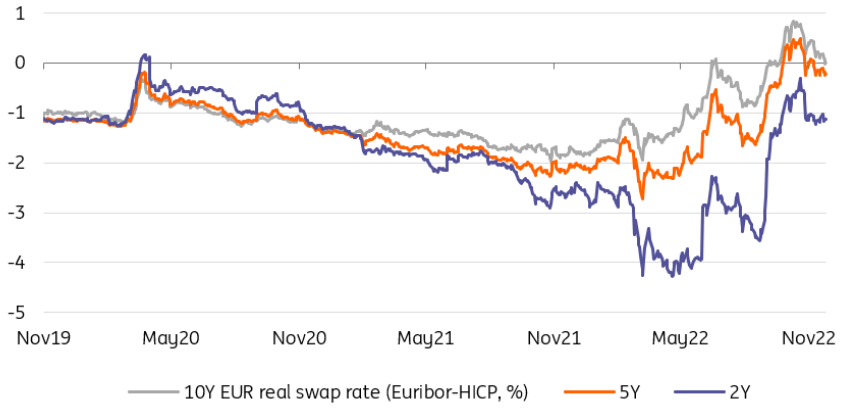
Explicit pushback against the market rally from ECB's Schnabel

ECB's Schnabel remained true to her role as prominent hawk. Her speech was a clear pushback against any notion of the ECB materially slowing its tightening process. She could hardly have become more explicit in her disapproval of current market developments, saying "market expectations of a pivot have worked against [the ECB's] efforts to withdraw policy accommodation." She highlighted that policy is likely too accommodative, with real rates still in negative territory for most tenors. That said, she is but one voice on the ECB, even if an important one.

Policy is likely too accommodative, with real rates still in negative territory for most tenors

The market's pricing of the December ECB meeting remains little changed at close to 60bp and also the terminal rate continues to hover just below 3%. The ECB minutes of the October meeting itself did not bring about anything surprisingly new, but served as a confirmation of media reports that already suggested the momentum for another 75bp hike in December was lower. Next week will see the release of the November inflation data, which in the end could tip the balance in the ECB's decision. However, the ECB has started to shift the focus of the discourse to underlying inflation pressures. This included Schnabel yesterday - stressing that these showed little sign of subsiding just yet.

Negative real rates on much of the EUR curve show policy is still accomodative



Source: Refinitiv, ING

The interdependence between TLTROs, QT and rate hikes

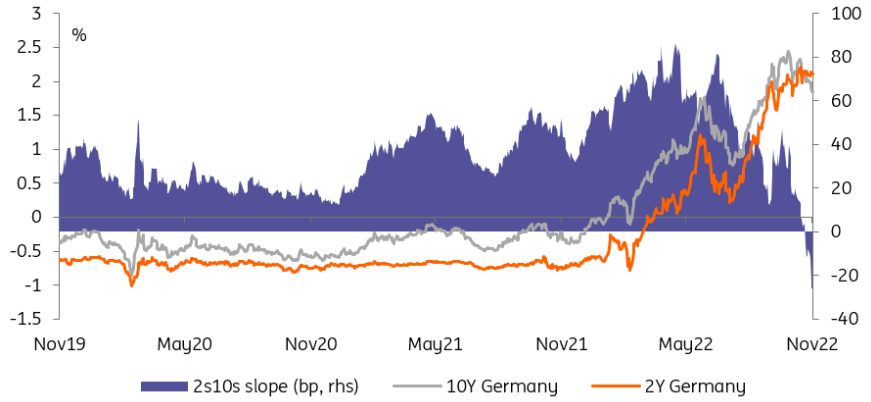
The ECB minutes provided some insight into the ECB's thinking on how the TLTRO changes fit into the broader balance sheet strategy. Reducing the TLTROs was seen as a necessary first step before considering the reduction of bond holdings. An assessment of the repayments after the adjustments of the TLTROs and impact of financing conditions would also inform the discussion to be had on reducing the reinvestments of the bond portfolio in December.

Reducing the TLTROs was seen as a necessary first step before considering the reduction of bond holdings

Clearly there is some interdependence between the TLTROs, QT and even rate hikes in the minds of the ECB. According to the minutes the Council deemed the TLTRO recalibration "more efficient" than trying to achieve the same objective through an earlier start of QT or more aggressive interest rate hikes. Clearly, the first voluntary repayment in November of €296bn was on the low

end of expectations and had also limited market impact. Ahead of the December meeting there will be one more repayment opportunity to consider. That amount will be closely watched as it could also be part of the bargaining process between hawks and doves when they decide on the pace of further hikes.

Curve flattening is not a typical reaction to more dovish central bank expectations



Source: Refinitiv, ING

Next week's events provide a crucial test to the market rally

Global rates have seen a significant rally over the past weeks, EUR 10y swap rates alone have pulled back 75bp from their peak in early October. The extent of the long-end rally seems to be more than just hopes for a pivot, noting also that front end rates have proven more stable, helping the strong curve flattening. A more technical component, where extensive short positioning has been reduced amid thin liquidity going into the Thanksgiving holidays and year-end, appears to be at play as well.

> *The extent of the long-end rally seems to be more than just hopes for a pivot*

The events lined up for next week will this provide a crucial test for the sustainability of the rally lower in rates. In the US all eyes will turn to Fed Chair Powell's speech on Wednesday. Of late he has taken a more hawkish line than the majority of the FOMC, as evidenced by his last press conference when compared to the subsequent FOMC minutes. On Friday the job market data will speak to the resilience of the economy, with expectations for a 200k increase in payrolls.

In the euro area ECB president Lagarde will be speaking to parliament on Monday. More important will the release of the preliminary inflation data, starting with first country readings on Tuesday and the Eurozone-wide measure in Wednesday.

Today's events and market view

Market liquidity should remain subdued, with the US only returning for a shortened session

in between yesterday's holiday and the weekend. There is little in terms of data to change the course of markets today, with only public appearances of the ECB's Muller and Visco being of note. But looking ahead that will change - with the crucial events lined up for next week.

We have seen a remarkable rally in rates, which has likely been underpinned by market conditions surrounding the Thanksgiving holiday and the nearing year-end. Given the technical facors at play we have already earlier expressed our doubts about the sustainability of this rally and believe that it could be put to the test next week by the Fed's Powell and in the eurozone by the release of the inflation data for November.

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