# Rates Spark: Three times policy error

Rates continue to gyrate, with all major curves – US, EU and UK – re-flattening as the front-end price in further tightening and the back-end rates move lower. More tightening now, requires less later. UK takes the lead with BoE seen hiking next month, but the seesaw between front-end and back-end rates also suggests that a policy error narrative is in play

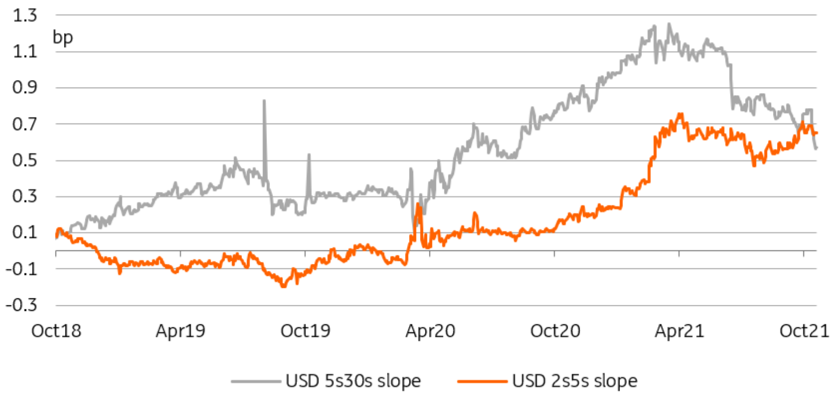

## US belly gets ever cheaper as the wind-up to an eventual hike continues

The positioning of the 5yr area on the US curve versus the 2yr and 10yr is now back to the levels last seen in 2016, on the eve of a series of multi-year rate hikes from the Federal Reserve. The curve is getting into prep mode for an eventual hike. A continued cheapening of the belly is likely in the near term, characterised by a relative flattening on the 5/30yr segment. But it's too early for this to be a structural thing. Some tactical re-steepening on this segment is very likely, as the curve faces into a very sticky inflation story.

*The curve is getting into prep mode for an eventual hike*

The next big step in this process would be for the steepening on the 2/5yr segment to morph into a flattening, as the 2yr yield shoots higher. This would make complete sense where a hike is expected within the next 3 months or so. We are not quite that close to a hike yet, so a 2yr convergence on the 50bp area would be enough at this juncture.

## As hikes are brought forward, 2s5s will re-flatten




Source: Refinitiv, ING

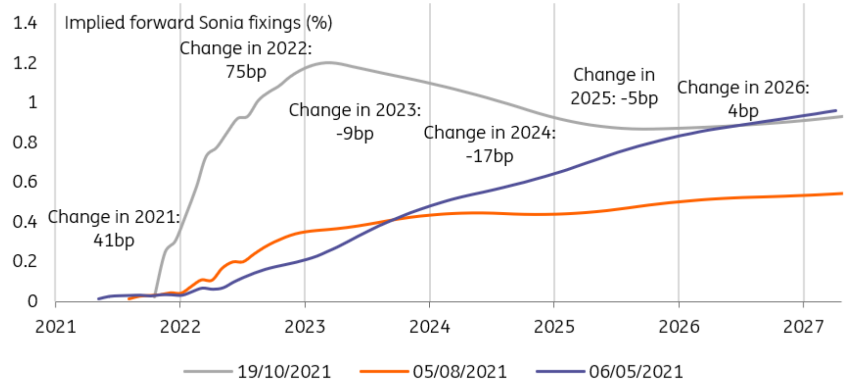
The missing element is that longer end rates are still not high enough to be fully prepared for a material series of interest rate hikes. The 10yr should ideally be closer to 2% for the runway to be set for a series of hikes. In consequence, the curve has upward potential, and in fact a tactical re-steepening one. Otherwise, the rate hike ambition cannot be realised.

## UK front end displays a telling hump

More policy tightening earlier on will require less tightening later can be one way of explaining the 5s30s curve re-flattening, as central banks are seen countering inflationary pressures more aggressively.

The Bank of England Governor Bailey said “monetary policy will have to act”, looking at the front-end pricing in GBP, and reinforcing the argument that the BoE is seen as the closest to tightening policies. This strikingly illustrates the other narrative: Central banks are close to committing a policy error. Why else would the market see the BoE hike rates more than 100bp by the end of next year, only to start lowering them in the years thereafter?

## The Sonia curve is pricing the BoE cutting rates back after 2022




Source: Refinitiv, ING

*Our UK economist has doubts about the BoE's ability to hike as quickly beyond the first move that is now priced*

Keep in mind what this implies for the BoE's balance sheet. At a bank rate of 0.5%, the BoE indicated that it would stop reinvestments. At a level of 1%, policymakers have indicated they will start actively reducing the balance sheet, i.e. selling assets back into the market. All else being equal, that should be an argument to see also long-end rates rise given the additional tightening it implies. That said, our UK economist has doubts about the BoE's ability to hike as quickly beyond the first move that is now priced.

## EUR curve jumping ahead of the conclusion

In the Eurozone, front-end pricing appears to be getting ahead of itself as well given the European Central Bank's own forward guidance. That is at least relating to the near future of say 2022 and where more than 10bp of tightening is currently priced. Some of that may just be cross-market spill-over effects from what is seen in the US and UK. But also the undertone of ECB policymakers recent comments, suggest an increasing worry about an inflation overshoot.

*The ECB is reducing purchases and its now more a matter of how to buffer some of the impact*

Our thinking is that the exit strategy should in the first instance impact the expected speed of a wind-down of the asset purchase programmes. And indeed, that seems to be the focus of many ECB officials judged with many opinions voiced on keeping the PEPP flexibility or how to tweak certain allocations to supranationals, for instance, as reported yesterday. The upshot is, the ECB is reducing purchases and it's now more a matter of how to buffer some of the impacts. That a substantial reduction of purchases is looming should be clear. In theory, this should register in higher long-end rates, bond underperformance versus swaps and wider sovereign periphery spreads over Bunds. None of that is to be seen currently.

It is even more surprising – or even worrying if one considers the outlook this implies – to see the long end dropping, considering how very subdued levels EU rates are to start with compared to the US and UK. That alone would suggest that EUR curves should be more inclined to steepen first before patterns that are usually more typical for a later stage in the cycle, set in.

## Today's events and market view

The data calendar is relatively quiet, but sees public appearances of quite a few central bank speakers. Speaking agendas suggest focus away from imminent monetary policy decisions. Given the proximity of the next ECB and especially BoE meeting, the market is prone to headline risks. While it appears the market has increasingly made up its mind given how far we have come in valuations, some inconsistencies in our view – see for instance in EUR as outlined above – suggest potential for reversals.

The US sees housing data and a busy slate of Fed speakers including Daly, Barkin and Bostic ("transitory is a dirty word").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