Rates Spark: Tightening goes global

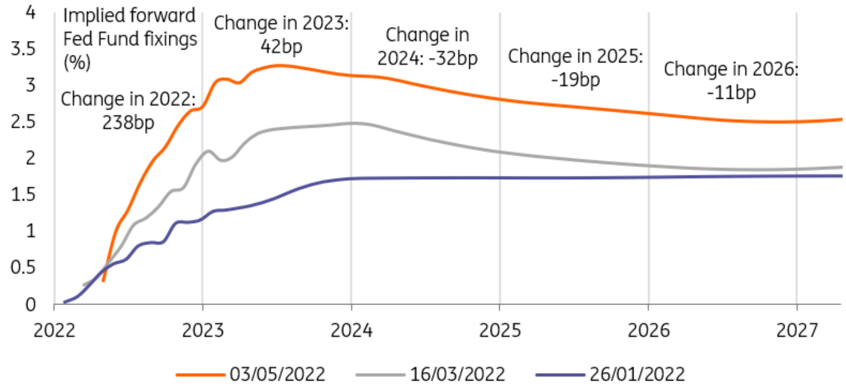
We argue that the Fed has to deliver on hawkish expectations, by hiking by 50bp today and announcing balance sheet reduction. This urgency has also pushed EUR rates up, despite the increasing likelihood of stagflation in Europe. This could flatten the curve, and push peripheral spreads wider

The US Fed is expected to deliver a 50 basis point rate hike

The Fed has no real choice but to be hawkish, and coy

We argue that delivery of a 50 basis point hike and a plan of action for imminent balance sheet reduction are bare minimum outcomes from the FOMC meeting. In our view, the only question is how fast will the Fed move to a USD95bn roll-off per month. Our baseline view is they start with USD50bn and take this to USD95bn by the end of the summer. But they could also decide to just jump straight in and do the USD95bn per month from the off. Even at USD95bn per month it will take some time before that really impacts the imbalance between collateral and liquidity that is plaguing the repo market. Remember there is some USD1.8bn routinely going back to the Federal Reserve on the overnight reverse repo window at 30bp, while secured overnight financing rate has tended to struggle to make that rate (although it did manage to get back up there yesterday).

The curve implies a Fed tightening cycle front-loaded to this year



Source: Refinitiv, ING

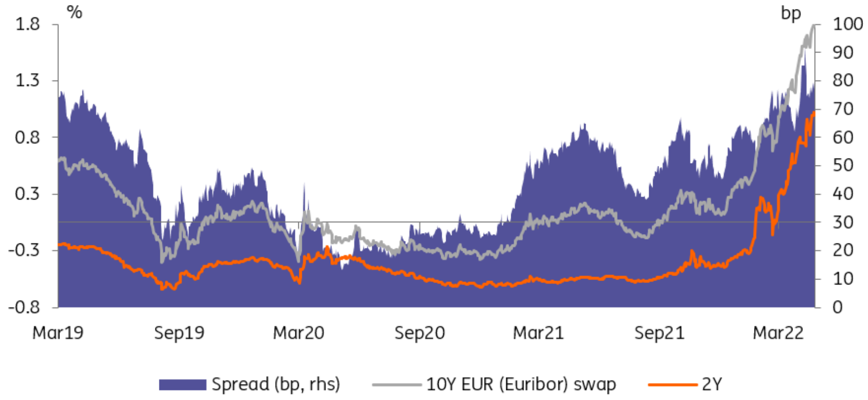
> *A 50 basis point hike and a plan of action for imminent balance sheet reduction are bare minimum*

The big question beyond that is the extent to which Chair Powell is prepared to go on setting the scene for a 75bp hike from the June meeting. In a way it's in the Fed's interest not to build such a discount too soon, if at all. Better, it could be argued, for a moderate probability for a 75bp hike to build, and for the Fed to then deliver on it, thus being seen to move ahead of the curve. So expect Chair Powell to be coy. The back story is clear though. Inflation expectations in the 10yr are too close to 3% for comfort, and the 10yr real rate is now back above zero, and looking up. In contrast the effective funds rate post the 50bp hike willl still be below 1% with inflation at over 8%. That implied real rate will become less negative as inflation is expected to ease in the months and quarters ahead, but the Fed will need to do their bit too. As it is, the funds rate needs to get to 3% to have a chance at closing the gap.

The Fed is also setting expectations for EUR markets

Of course, the Fed scrambling to tighten policy and get inflation under control will have repercussions far beyond the US' shores. Its urgency in raising interest rates has pushed other markets to conclude that a commensurate amount of hikes will be implemented by central banks across the world. The Eurozone, which managed to cut rates by 20bp during the Fed's 225bp hiking cycle in 2015-18, is no exception.

Growing stagflation risk should flatten the EUR curve



Source: Refinitiv, ING

> *Markets are in no mood to challenge the amount of hikes implied by the swap curve*

So far, inflation readings in Europe are on the ascent, leaving markets in no mood to challenge the amount of hikes implied by the swap curve (over 200bp in roughly 18 months). This comes against a backdrop of worsening risk sentiment which has investors increasingly fearful of a stagflationary outcome in Europe. This wouldn't be great news for bonds, insofar as inflation would still warrant at least some degree of ECB tightening.

But risk assets would likely fare worse, under the joint threat of global monetary tightening (whether the ECB delivers on the market expectations or not) and of a slowing global economy. Counter-intuitively, this could still benefit safe havens, such as bonds. Provided inflation is expected to decline eventually, which seems likely in the event of a recession, long-end rates could be back in favour, and so a flattening of the curve would be on the cards.

High beta fixed income looks at risk as the ECB steps back

Riskier bonds, no longer benefitting from central bank support, nor from the rising tide of economic growth, look particularly vulnerable. The case for peripheral sovereign bonds at the moment is poor. The ECB's stepping away from net purchases, likely as soon as June, means investors can no longer count on its daily intervention to smooth volatility and reassure the most risk-adverse investors.

Italy-Germany 10Y spreads are on their way to testing the 200bp level

Source: Refinitiv, ING

The hope of future intervention in case of excessive 'fragmentation' is a meagre consolation. For one thing, recent press reports suggested intervention would occur in case of sharp adjustment higher, implying investors could still face steep mark-to-market losses if the spread widening is slow enough. The relatively gradual 90bp widening in Italian spreads since the end of 3Q 2021 suggests the threshold for intervention is pretty high, so do ECB officials dismissing the significance of spread widening since last year.

> *Our initial view was that the ECB would change its tune once the Italy-Germany spread reaches 200bp*

The same officials also suggested that no facility to counter spread widening is currently in place, nor is being discussed. We could assume that the ECB, thanks to its experience in designing past programmes, would react relatively quickly but we wouldn't underestimate the hawks' opposition at a time inflation is on the rise. This says nothing of the numerous legal, and likely political, hurdles to yet another programme. Our initial view was that the ECB would change its tune once the Italy-Germany spread reaches 200bp; let's see if it does. If not, we expect the widening to accelerate as markets test the ECB's spread pain threshold.

Today's events and market view

The main event today will be the FOMC meeting and associated press conference. We expect the Fed to deliver a hawkish message and to hike by 50bp (see above).

Of today's Eurozone PMI services, only the Spanish and Italian indices will be first releases. Both are expected to edge up after the surprising resilience of their core country counterparts in April. Eurozone retail sales completes the list of European releases.

Germany will be back top primary markets with the sale of 10Y green bonds.

The US session going into the FOMC meeting will be lively with no less than mortgage applications, trade balance, ADP employment, and ISM services.

The US Treasury quarterly refunding announcement will disclose the size of note and bond auctions in the three months through July. On Monday, it announced a net paydown of $26bn over that period but without giving a maturity breakdown. Despite solid tax intake, the start of quantitative tightening will make debt management decisions trickier for the Treasury going forward.

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