Rates Spark: U-turn week

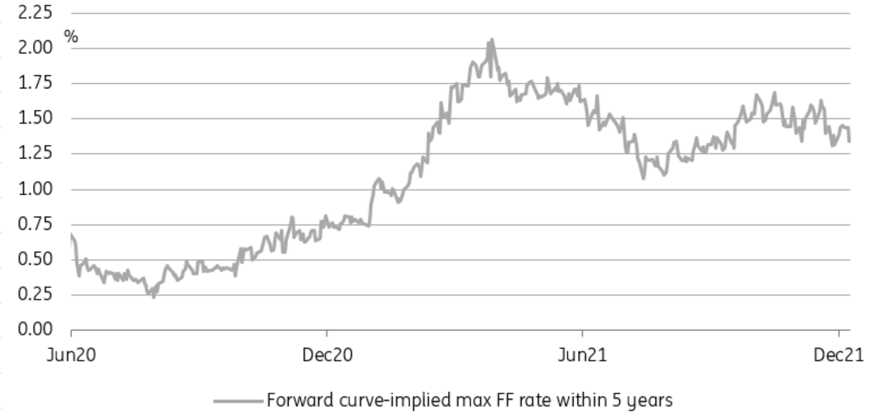
The Fed's hawkish shift looms large over rates markets, and overshadows more dovish decisions by the BoE and ECB. We view long-end rates as capped, but short yields could make more headway, for instance on an upside US PPI surprise.

Source: Shutterstock

A cap on long-end yields

Price action in rates markets suggests that the most momentous central bank decision to be made this week will be a hawkish shift from the Fed. This is at least what we conclude looking at the continued flattening of yield curves globally, led by USD. This is in line with our tactical view, even if encouraging data on the severity of omicron cases poses a risk to our expectation. Pending a more definitive assessment, the reality of ever tighter health-related restrictions on economic activity contributes to dampen any upward momentum in yields, keeping 10Y Treasuries below 1.5% and 10Y Bund below -0.3%.

The market's implied Fed Fund terminal rate has dropped ahead of the Fed meeting



Source: Refinitiv, ING

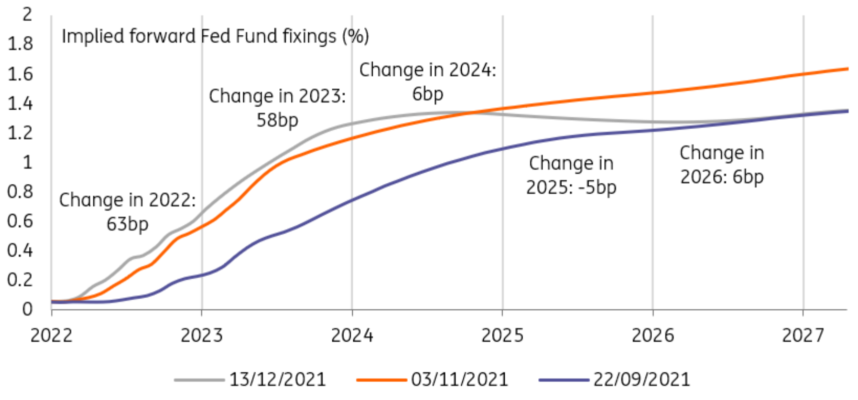
Restrictions on economic activity contribute to dampen any upward momentum in yields

With yield curves flattening, it is worth reminding ourselves of how much tightening the market implies from the Fed. Despite what promises to be one of the most notable hawkish U-turns of recent history (dropping the idea that inflation is transitory, opening space for a March hike, accelerating tapering just one meeting after it started, probably a jump in the median 2022 dot), the terminal rate in this cycle has actually declined in recent days, to 1.34% according to our calculations.

And more flattening on the cards

This is consistent with the way rates have been trading in recent months (in fact, since the Spring) but not with what the Fed is signalling: a long term Fed Fund at 2.5%. Low long-end rates are a major obstacle in the Fed's ability to tighten policy as much as it intends, but the balance between supply and demand will shift by the time the Fed Fund rate reaches the market's implied terminal rate. For instance, higher FX-hedging cost should reduce foreign demand, and quantitative tightening might also bite.

2024 OIS pricing looks most at odds with Fed projections



Source: Refinitiv, ING

Government bonds will remain very much in demand into the new year

This is not how we think markets will trade in the near-term, however. As they brace for a hawkish Fed meeting conluding tomorrow, overshadowing more dovish decisions by the ECB and BoE on Thursday, we expect more flattening to take place. This view is reinforced by waning supply (today brings the last two regular EGB auctions of 2021) and continued ECB buying until 21 December. One can also point to stretched T-bill yields as a sign that government bonds will remain very much in demand into the new year.

Today's events and market views

Italy and Austria will carry out the last conventional bond auctions of the year today, selling respectively 3Y and 10Y debt.

European economic releases will be few and far between, with European industrial production the main item, so we surmise most of the focus will be on their US counterparts in the afternoon. These consist of NFIB small business optimism and PPI. The latter is probably the data with the most market moving potential, with the headline expected to accelerate above 9% Y-o-Y. Note however that Friday's CPI print actually saw Treasuries rally when it came in line with expectations.

We see 10Y government bond yields as essentially capped into this week's 'triple witching' (Fed/BoE/ECB) policy meetings, but shorter yields could make some further headway.

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