

Rates Spark: What will markets make of the Fed?

The Federal Reserve typically delivers what is discounted, which makes a 75bp hike likely today. But then what? And what of the 50bp that was promised at the last FOMC? In fact a 50bp hike would inject some sense into the equation. Moreover, the rise in market rates has come from higher real rates, which tighten conditions, requiring less from the Fed



Federal Reserve

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Delivery of a 75bp hike should happen as that is what is discounted. But 50bp was what was promised...

It is quite unusual for the Fed Chair to stand up after an FOMC meeting and explicitly signal a 50bp hike at the next one, only to then deliver something different. But that is precisely where we are as we face into today's meeting. A 75bp hike is fully discounted, and because it is fully discounted, that is what is likely to be delivered. This is not the market forcing the hand of the Fed. The build of the market discount has, it seems, been steered by the Fed itself, as well placed soundings were placed with the press, in effect pre-warning the marketplace that a 75bp hike was in the pipes.

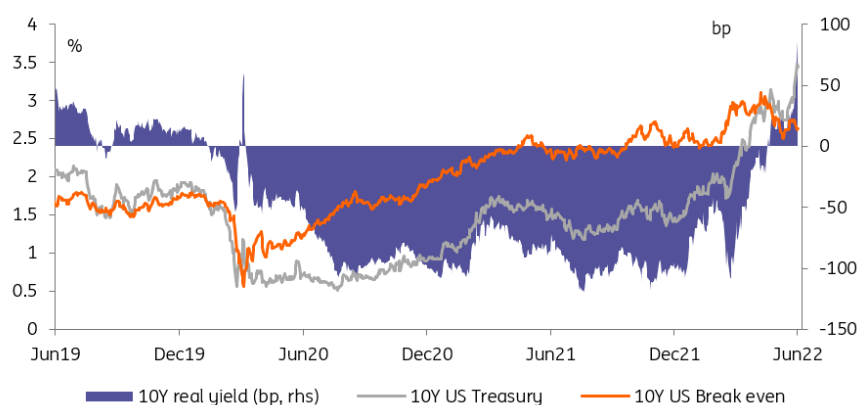
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Arguably the bigger story here is not the 75bp hike, but rather the way in which it has elbowed out the 50bp hike that had been boldly pre-announced. If the Fed were to go ahead and deliver on that promise of a 50bp hike it would cause quite a stir, as it would deviate significantly from the market discount for a 75bp hike, and in a way that is contrary to the direction that the Fed needs to go here. If the Fed were to deviate from the market discount, logically it should then be going for a 100bp hike. All things considered, we think the Fed will deliver on the discount for 75bp.

It makes forward guidance come across as no more than a hunch

It leaves the market in an uncomfortable position though. If the Fed were to assert after this meeting that it intends to do another 75bp in July, the market could not rule out 100bp. Or indeed a 50bp hike. It makes forward guidance come across as no more than a hunch. Nothing particularly wrong with that, but it does reduce the value attached to such guidance. All of this has contributed to the ratchet higher in market rates, and the sense of angst in the risk asset space. A seemingly bold 75bp poses more questions than answers, and any explanation forthcoming will be open to an overlay of doubt.

Higher real rates are helping the Fed in tightening financial conditions



Bond market angst has mostly centred on significant rises in real rates, not inflation expectations

Friday's US inflation print has clearly been the catalyst for latest bond market angst, but in fact the big driver for higher market rates has not come from inflation expectations. They have actually eased lower in both the US and the eurozone. Rather the big push for higher market rates has

come from higher real rates. This is something we were looking for anyway. The inflation print just accelerated it. And we are still not there yet. The US 10yr real rate is still below the 1% seen in 2018 (now at 80bp). And it's still negative in Germany (-50bp). That's a first point of warning for higher market rates.

It still does not feel like market rates have yet peaked

Second, the 5yr area is still cheap to the curve. Yes, the US 5/10yr has re-inverted. But the 2/5yr has not. And even if it does get forced into inversion, the curve still does not signal an imminent structural fall in market rates. Discounting a recession is still premature. Better for now to discount an uppity economy, with too much inflation and a labour market that is still far too tight. Given that, it should be no surprise that the curve is now in the 3.5% area. We had anticipated a move to the 3.25% to 3.5% area. Now that we are here, it still does not feel like market rates have yet peaked.

Today's events and market view

Further rises in real rates will act to slow things, and further tighten conditions, in line with wider credit spreads. This in fact takes pressure off the Fed to overdo it, and these market moves are a tightening all of their own, just as mortgage rates topping 6% do the same. A 75bp hike adds to this. But we're not ready yet to call a peak for market rates.

And the eurozone isn't either. In fact the European Central Bank has yet to get its first hike off the ground. The 10yr Bund yield now at 1.75% paves an open space for the ECB's refi rate to close, and can be gleaned even more clearly from the 2yr German yield now at 1.25%. Market pressure to do more than basic 25bp continues to build.

In data markets will get the US retail sales release ahead of tonight's FOMC meeting, where weaker auto sales will depress the headline figure. But decent strength in other parts should still give a positive figure overall. In the Eurozone the industrial production data will take a back seat given the busy slate of ECB speaker's scheduled for today, including President Christine Lagarde and Austria's Robert Holzmann.

Board member Isabel Schnabel stepped up the ECB's commitment to prevent financial fragmentation that would see borrowing rates in some countries rise faster than in others but stopped short of giving the outline of what a new facility would look like, or of saying which spread levels would warrant intervention. The ECB will be holding an emergency meeting of its governing council to discuss market conditions today. The spread between Italian and German 10Y bonds crossed 240bp yesterday, just shy of the 250bp level we identified as the next likely level to be tested absent an ECB intervention.

In Eurozone government bond supply Finland will sell up to €1bn in a 20Y bond reopening.

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