

Rates Spark: Whatever it takes, until it breaks

The Bank of England showed that central banks will not be shy to tighten more if disinflationary dynamics don't materialize. A reaction function more geared to current data than to being forward looking biases yield curves flatter - until something breaks.



Bank Of England,
London

Source: Shutterstock

Deeper curve inversions highlight potential costs of tightening too far

The initial market reaction to the [Bank of England increasing key rates by a larger than anticipated 50bp](#) increment to 5% was revealing. Yield curves twisted flatter, with outright drops in the 10y rate as the more aggressive approach by central banks is seen as coming with an increasing economic cost. Curves staked out new post-March lows although the move lower in long end rates later faded.

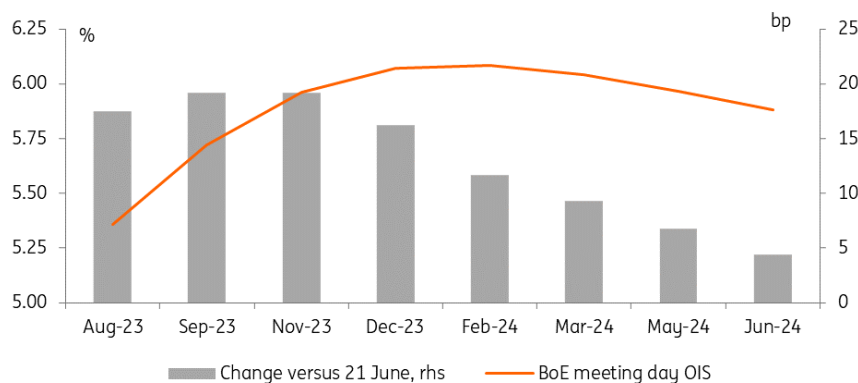
BoE shows central banks wont be shy to tighten more

if disinflationary dynamics don't materialize

What sticks is the sense that central banks will remain hawkish and won't be shy to increase rates further should the lack of disinflationary dynamic warrant it. In any case markets think the BoE has shifted to a more aggressive reaction function, with an even greater focus on current inflation dynamics. After yesterday's 50bp hike, another 50bp in August is seen as more likely than not. In total, a further 110bp of tightening is discounted in forwards, implying expectations that the BoE will take the terminal rate above 6% before year end. This is a view that our economist does not share, seeing only two more 25bp hikes eventually being realised.

The question remains how far central banks can credibly take the tightening, with record curve inversions pointing to stretched levels. Macro indicators such as, in the US, the Conference Board's Leading Index are also signalling recession. Today's release of the June PMI flash estimates could also serve to highlight the growing discrepancy between the central banks' own optimistic macro outlooks and the softening data indicators, but they alone are unlikely to resolve the disconnect.

More front-loaded tightening seen after the BoE's hawkish surprise



Source: Refinitiv, ING

Next week offers key inflation data

Sticky core inflation could remain the key theme for next week. Even if there were some positive surprise, central banks have made it clear they want to see a trend for the better in inflation data. By definition that will take a couple of releases at least, but it won't keep forward-looking markets from extrapolating any incoming data points. That difference can still keep a curve flattening bias in play.

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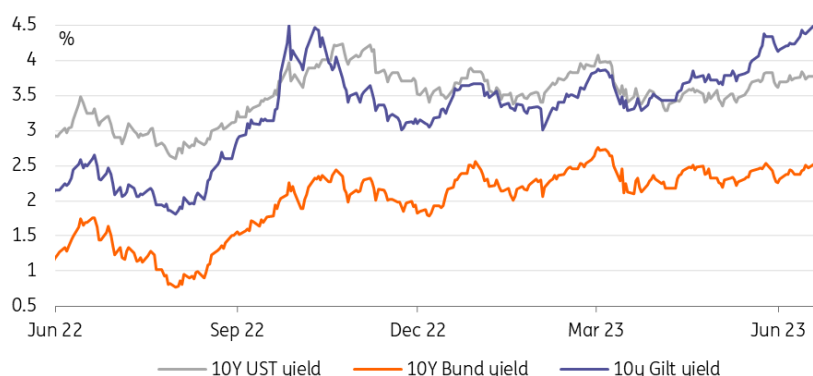
In the US the key release to watch is the PCE inflation data at the end of the week. The headline rate is seen lower, but the consensus is looking for both the monthly and yearly core readings to remain unchanged, at 0.4% and 4.7%, respectively, after their upward surprise last month. Stickier

core inflation could still validate the Fed's hawkish case, but with a lower headline that might not be enough for markets to endorse the two more hikes implied by the FOMC's latest "dot plot".

In the eurozone markets will be closely following first the individual country inflation data before we get the June CPI estimate for the block on Friday. The market eyes a decrease in the headline rate to 5.6% year on year, while our economists have pointed out that within core, services inflation continues to [see some upside risk for the months ahead](#).

Ahead of these key releases central banks will have plenty of opportunity to lay out their current reaction function, with the ECB's central banking forum in Sintra kicking off on Monday. The main event will be a policy panel attended by the ECB's Lagarde, Fed's Powell, BoE's Bailey and BoJ's Ueda.

Gilt yields higher, but Treasuries and Bunds still appear capped for now



Source: Refinitiv, ING

Today's events and market views

Through all the key central bank meetings of the last few weeks, it is notable that the trading ranges for longer-dated EUR and USD rates have held, resulting in the overall curve flattening move. The difference to the UK is that that, inflation-wise, things have been moving in the right direction, even if only slowly. Still, it does look as if there is a stronger will to test the upside and we would not exclude that 10Y UST yields hit 4% again before going lower.

For now, an eventful week will be capped off by the release of the June PMI flash estimates. In the eurozone last month brought a pretty bleak report as the PMI indicated that services experienced slower growth and manufacturing experienced a sharper contraction. Consensus is looking for services growth to slow further, but the manufacturing slowdown to at least stabilise. Last month's main upside was around fading inflation expectations.

Central banks will want to rely on the actual inflation readings, where the UK has shown that in the current circumstances, one reading disappointing to the upside can make quite a difference. The next key inflation releases out of the US and eurozone are what markets can look forward to towards the end of next week.

Author

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

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