Rates Spark: When the dust settles

Bringing forward Fed hikes is the logical conclusion of an eventful week, but reflation trades are running counter to the theme of a hawkish Fed. The Bank of England meets today but caution should prevail, making it hard to validate the market's conclusion that earlier rate hikes are on the cards

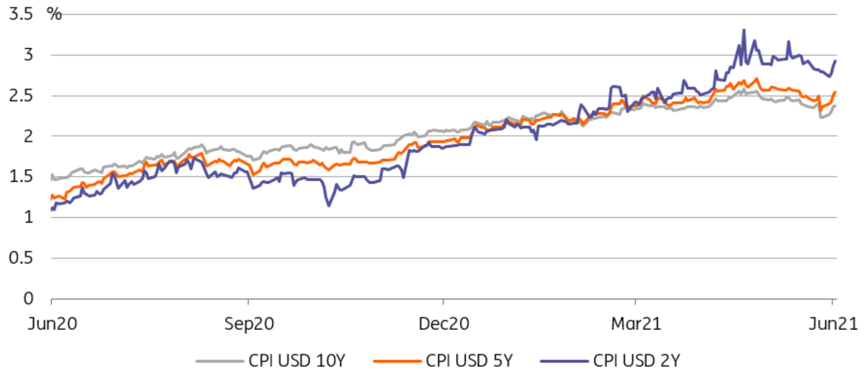
Source: Shutterstock

Fed flip-flopping but reflation trades have peaked

The past week has been an eventful one, to say the least.

When the dust settles, we think bringing forward Federal Reserve hikes was the correct call for rates markets, even after Fed Chair Jerome Powell struck a more cautious tone at this week's testimony than at the FOMC last week. The latest comments have prompted a recovery in long-dated reflation trades, for instance, a re-steepening of the US nominal rate curve and a rebound in inflation swaps.

Inflation swaps have bounced this week thanks to Powell's flip-flop



Source: Refinitiv, ING

This last move supports the view that a lot of the price action seen since the FOMC has as much to do with an unwinding of reflation trades as it has to do with a change in macro views. The issue is, both lower inflation swaps and a flatter curve make sense if the Fed is going to hike earlier than previously thought, so we hold on to the view that this cycle’s peak has been reached in both.

What is harder to justify is the lower outright level of rates

What is harder to justify is the lower outright level of rates, even at the back-end. The usual caveats apply, including low rates and dovish central banks in other major developed markets, but US 10-year trading around 1.5% is only consistent with a degree of macro angst that we do not see in economic data. This being said, macro risks abound.

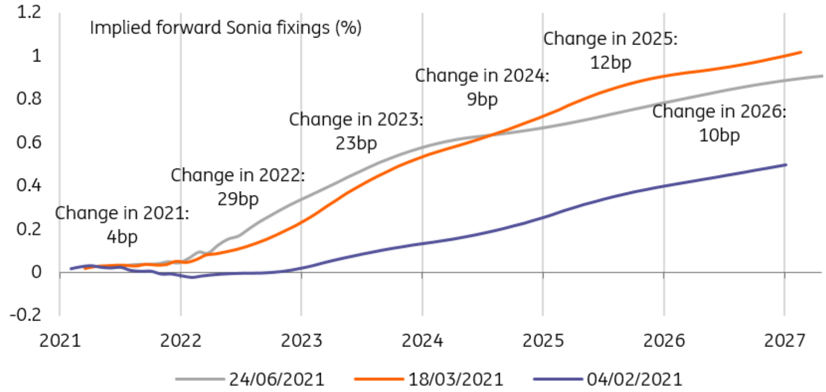
The usual warnings about a potential Covid-19 wave apply but feel more pressing now that the delta variant has gained a foothold in many countries.

Bank of England: Hikes are coming but caution should abound

The topic of the read-across from the FOMC change of tone to foreign central bank policies will be on display at the Bank of England meeting today.

Given the absence of an update to the inflation report, and a press conference, communication should be easier to manage for the central bank, and likely to result in a disappointment to those hoping for an early hike signal. At a push, a display of optimism could be used to validate hike expectations, but this will probably require a strong helping of confirmation bias.

GBP rates have also brought forward BoE hikes



Source: Refinitiv, ING

Reasons for caution abound, and centre on the impact of the resurgence of Covid-19 on the reopening and growth. Against that, the outlook has definitely improved but, like the Fed until recently, the BoE had argued that the current inflation flare-up will prove temporary.

Nonetheless, this doesn't feel like the time or place to send a message like the FOMC just did, even if markets may be right that the first hike could occur as early as 2022.

Today's events and market view

The Bank of England meeting is the highlight today but by no means the only event likely to move markets.

The list of central bank speakers does not include BoE governor Andrew Bailey but includes a raft of Fed officials and Isabel Schnabel of the ECB. From recent comments, it seems that governor Powell is sitting towards the dovish end of the FOMC so comments from other officials might prove less soothing for reflation trades (see above for examples). New York Fed President John Williams might be the exception to that rule. On the ECB front, its dovish tone has allowed EUR rates to take a more sanguine view of the recent developments. We expect no departure from this line today.

German IFO survey and US durable goods orders are the potential flashpoints of the release calendar. There is also US Q1 GDP but this is a slightly dated data point and the third release of this indicator.

Italy mandated banks for the sale of a floating rate note that we expect to price today.

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