

Article | 5 November 2021

RATES

Rates: Terminal levels for the US and eurozone

At the beginning of every rate hiking cycle, there are two key questions: when will it start and how high will rates go? We use the forwards to help formulate terminal rate estimates, and the 2yr to help decide on timing. We find that the timing is far from imminent, but the forwards suggest there is quite a hiking job to get done in the years ahead



Source: Shutterstock

Rate hikes galore, but what about the US and eurozone

It's been a remarkable few months as markets have collectively re-calibrated rate hike expectations higher, pushed there mostly by the persistence of inflation. Central banks spanning Norway to New Zealand have already hiked rates, as have a series of Latam ones. In central Europe the likes of Hungary and Poland, having been on an official rate downtrend over the past decade, have succumbed to the need to hike. And there are many others, including the likes of Czech, while the UK remains close to pulling the trigger.

The “when do we start?” and the “how much in total?” are key

issues

But what about the US and eurozone? There's certainly been a built-in rate hike expectations. But the "when do we start?" and the "how much in total?" are key issues. We have views on both questions, but there is also a market discount that can also present some answers. A starting point is what the forwards are discounting. Forwards are backed out of the shape of the current curve in the form of break-evens. These then represent unbiased predictions of how high rates are expected to go.

Market terminal rate for the US is 2%, and 70bp in the eurozone

There is a keen focus on the US, given how pivotal the Federal Reserve is. Here we find that the 5yr to 10yr part of the curve plateaus at around the 2% area in the forward space (chart below). The 5yr tends to get there 5yrs forward and the 10yr gets there at around 3yrs forward. There is then a flatlining at around 2%, practically no matter how far we go forward. This is as good a measure as any, of the terminal rate for the Fed funds rate.

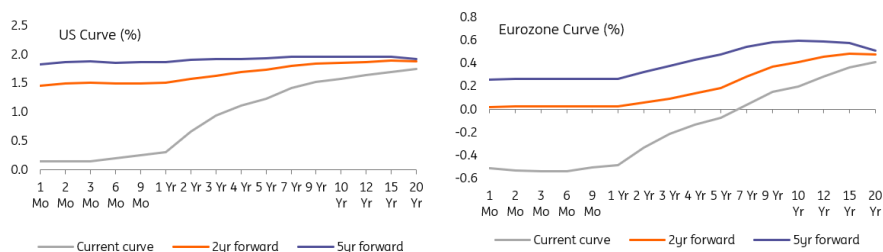
The EUR curve is telling us that 70bp is a terminal rate discount for the ECB's refi rate.

Performing the same analysis on the EUR curve shows that we need to go further out in the forward space to get to a flatline, and the implied terminal rate from that plateau is in the 60bp to 75bp range in the forward space (chart below). The 10yr in fact never gets much above 60bp, and the 5yr hits just north of 70bp when pushed 10yrs forward. Without getting too bogged down in specifics, it seems that the EUR curve is telling us that 70bp is a terminal rate discount for the ECB's refi rate.

These are not far off our own predictions, where we see the Fed settling in the 1.75% to 2.0% area, while the ECB gets up to 75bp (both slightly above the implied market discount).

Current curves versus some forward ones

The US and eurozone compared



Source: Macrobond, ING estimates

Why the 2yr rate is a good guide on what's really discounted

And what about the timing? Here we look at the 2yr rate. Why the 2yr rate? It is long enough to incorporate a robust view of where rates are heading to, without being too long where things can get quite fuzzy (the further we go into the future). In the eurozone, the 2yr swap rate is at -30bp. Even the 2yr rate set 5yrs forward is at just 30bp. If rates are really heading higher in the next few years, these valuations would need to be higher.

In the US, the rate hike discount is more pronounced, but still not dramatic. The 2yr USD swap rate is at 65bp. The 2yr forward rate is 100bp higher, at 1.65%. And we need to go to 5yrs forward to get to the 2% area. While there is a non-linear relationship between the level of rates and the shape of the curve, it does seem to us that the absolute level of front end rates remains low relative to where they could be, given where terminal rates are pitched.

Bottom line, the market discount is one where terminal rates of 2% and 70bp are operable for the US and the eurozone respectively. But the front end casts doubt on these, as front ends are not discounting an imminent increase in rates, and the longer it takes, the fuzzier the outlook becomes in terms of hitting those terminal rates.

Author

Padhraic Garvey, CFA
 Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.