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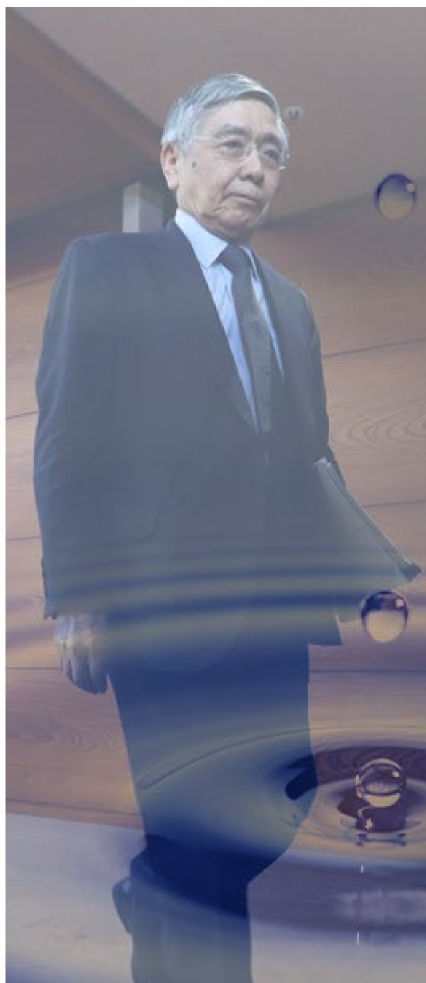
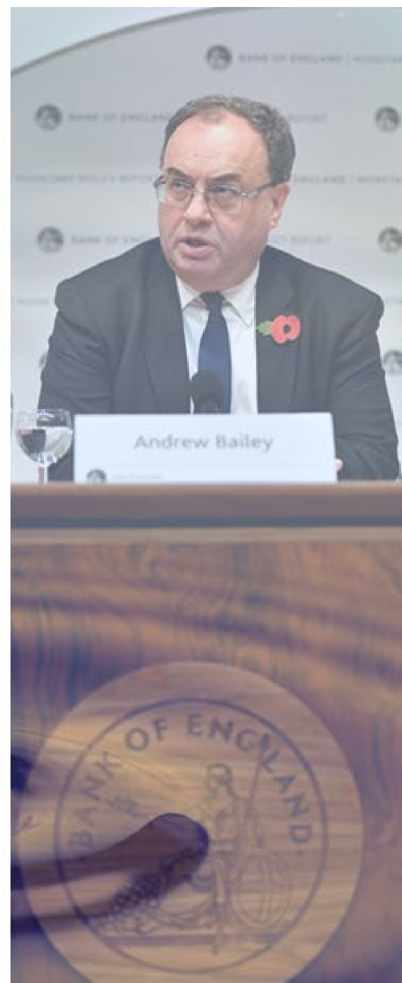
Rates outlook 2022

The liquidity overflow recedes

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The liquidity overflow recedes

The year ahead will feel quite different to the year just gone. The warm cloak of liquidity will feel that bit less secure as conditions begin to tighten up. Overt US rate hikes will add to that, as will talk of ECB ones to come. Market rates should be running ahead of this, pulled there by inflation. Fixed income demand and lower net supply will mute rate rises

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1 The price of liquidity should rise as it becomes less abundant

One of the key themes for 2022 and into 2023 centres on the reversal of the various avalanches of central bank liquidity that have dominated in the past number of years. For the US, the re-injection of liquidity, mostly through bond buying by the Federal Reserve, was pandemic related. For the eurozone, it's been an ongoing process right back to the years following the great financial crisis, one that morphed into a sovereign debt crisis. Masking problems with liquidity has been a popular policy response. It's quite an opaque tool, but one that has likely kept the eurozone intact, and more recently has helped to facilitate an impressive recovery in the US. And the latter has been crucial for recoveries elsewhere.

Things are different as we head into 2022. Central banks are eyeing an end to bond buying programmes. The Bank of England is on the verge of ending its programme, following on from the Bank of Canada. Federal Reserve Chair Jerome Powell is now talking of an accelerated taper, and in all probability the European Central Bank will have ground its bond buying programme to a halt by the end of 2022. Even if we stop there, these are huge developments. But there is a reasonable possibility that some central banks take the next step by allowing bonds to roll off the front end, and beyond that either repoing bonds back to the marketplace or go hard and sell bonds back to where they came from.

As the price of liquidity is effectively the interest rate, any reduction in excess liquidity should place upward pressure on market rates, especially where liquidity shrinks. The ECB will increasingly set the scene for an eventual unwind of the likes of the TLTRO. The Federal Reserve will begin to reduce bank reserves at the margin, which will make conditions feel that bit tighter. And the Bank of England may well take the biggest step and allow bonds to roll off the front end, thus securing purposeful shrinkage in its balance sheet. These will be quiet moves behind the scenes that will place upward pressure on market rates.

2 Elevated inflation and rate hikes pulls curves higher from both ends

The other key drivers of market rates are more straightforward - inflation and the need for central banks to react to it through interest rate hikes. The latter will, by definition, push up front end rates, certainly in the US and UK, as they hike in 2022. But the eurozone too should see some upward pressure on the front end as we gear up for a rate hike cycle that we expect to begin in early 2023.

The response of the marketplace to inflation is a tad more complex. It should not be, as inflation is an outright negative for fixed income. But we've seen in 2021 a remarkable resilience to some quite severe spikes in inflation in the US and the eurozone. Market rates are higher as a theme in 2021, but it's been quite a tough lift.

For 2022, as inflation remains an unresolved issue, upward pressure on market rates will continue to emanate from it. It may not be the dominating factor, but it is one that is not going away as easily as some had predicted. Ask Chair Powell.

3 Supply versus demand dynamics will dampen the rise of longer rates

At the same time, we can't forget that demand for fixed income has had a key dampening effect on the ambition for market rates to rise in 2021. This reflects the impact of overseas demand for US Treasuries, quite aggressive central bank buying and technical buyers like corporate fixed rate receivers, pension fund buyers as a natural hedge for liabilities and the required re-calibration of bond/equity proportions as equities rallied in 2021 (and 2020).

Many of these factors will remain in play for 2022. But many won't, like central bank buying, and the environment for risk assets is likely to get tougher.

The other wrinkle that we observe is lower net supply of government bonds for 2022. This will make supply pressure feel less heavy. In the US, we find that the reduction in net supply is comfortably in excess of the loss of Fed bond buying for example. This dampens supply as a driver for higher rates in 2022.

In fact, it should allow for some re-richening in government bonds versus swap curves. Especially in the US, where USD Libor persists, and is likely to come under rising pressure, reflecting tighter credit conditions generally. This occurs against a backdrop where US rates should continue to lead eurozone rates higher, widening spreads between the two.

> So there are lots of moving parts for 2022, and many of them are conflicting. In net terms, we see higher market rates as winning out. We target the US 10yr to hit 2% and the eurozone 10yr to get to 50bp, and keep rising. That effectively requires a repeat of the net rises in market rates seen in 2021. But expect some big, fast moves in 2022. The 10yr should make the big move in 1Q, and the 2yr at the latest by 2Q. That will set the scene for the subsequent delivery of rate hikes.

If the 10yr Treasury can't hit 2%, the Fed can forget about it too

The 10yr rising to 2% in 1Q and the 2yr at 1% by 2Q are key calls for 2022. This would pave the way for Fed rate hikes in the second half, with more following in 2023. Before that, the curve needs to re-steepen, but subsequent flattening should dominate for 2022 as a whole. Conditions should tighten too, as the debt ceiling is lifted and bank reserves are reined in

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Heading for 2%, and prefer higher than lower beyond that

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y USD swap	1.55%	Higher	1.5%	2.00%	2.25%	2.25%	2.25%

US direction - being pulled higher from both ends

The journey from sub-1% for the US 10yr to the 1.5% area has been the story of 2021. The move, in fact, played out in the first quarter. For the rest of the year, the struggle was to make a material and sustained break away from the 1.5% area to the upside. The elevated inflation dynamic presented an open goal for higher market rates. After all, nominal rates contain an explicit inflation component.

That said, the remarkable demand for fixed income throughout the year continued to dominate available supply, where availability has been curtailed by central bank buying. Although the Fed will wind down the bond buying, their bloated balance sheet will continue to constrain the volume of available securities on the marketplace.

"The 2% handle for the nominal 10yr is an ongoing call for us, one that we roll into 2022"

These themes will persist as we journey through 2022, and on balance, we see enough to tempt market rates higher still. The 2% handle for the nominal 10yr is an ongoing call for us, one that we roll into 2022. Getting there has been a tough nut to crack, but we remain of the opinion that elevated inflation along with the delivery of rate hikes should be enough to pull the curve higher from both ends.

"On the front end, the 2yr should be targeting a handle of 1% by mid-year"

Large negative real rates are an anomaly that should fade, assuming the post-Covid recovery is a structural one, which we indeed assume it is. The ultimate goal would be to get to a zero real rate in the 10yr, but it may not be till 2023 before that happens. On the front end, the 2yr should be targeting a handle of 1% by mid-year, and closer to 1.5% by the end of the year, as the Fed delivers two 25bp hikes (with three more to come then through 2023).

Steeper from back end, but then flatter from the front end

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
USD 2s10s slope	80bp	Flatter	75bp	100bp	75bp	50bp	40bp

US curve - The Fed will want the curve to steepen before coming in to flatten it

Typically, three to six months before a first hike is when the 2yr really begins to sit up and take notice, and can then trade some 100bp over the funds rate. Currently, we are in the wind-up phase, where a steady grind higher in yield dominates. During this preliminary phase, we can and should see some re-steepening of the yield curve, as back-end rates begin to make way for future rate hikes. This is an important phase, as the degree to which the 10yr yield rises will determine the extent of rate hikes the Fed can ultimately deliver. This is why getting to a 2% handle on the 10yr is a minimal first step if the Fed has an ambition to get the funds rate anywhere close to that down the line. If not, the Fed would find itself inverting the curve through hikes, which is traditionally not what it wants to do.

The call on the 2/10yr segment is for it to steepen first from the back end. It has flattened into the 80bp area (65bp on swaps) in the past number of weeks, but ahead, we'd expect it to see 100bp at least one more time. The driver should be a relative steepening on the 2/5yr segment versus the 5/10yr segment, as the 5yr area continues to underperform.

"The dominant move over the course of 2022 is liable to be flattening"

That said, the dominant move over the course of 2022 is liable to be flattening as the 2/10yr segment ends the year at closer to 50bp. The key driver of this is the delivery of Fed hikes. The anticipation of these hikes is what drives the 5yr cheaper to the curve. Actual delivery should prompt a re-richening of the 5yr and a flattening of the curve led by the 2/5yr segment, as the 2yr shoots up to move closer to the 5yr. In the background, the 10/30yr should have flattened out to zero, leaving the 5/10yr as the steepest segment on the curve by the end of the year.

SOFR for new business, but USD Libor remains a player for 2022

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
Libor 3M	20bp	Higher	25bp	30bp	40bp	60bp	80bp

US money markets - Debt ceiling elevation plus bank reserves shrinkage to push rolling rates up

When we turn to the ultra-front end there is only one game in town as we flip from 2021 to 2022, and that's how the debt ceiling is dealt with. As it is, the US Treasury is right up against it, and in consequence needs to be careful in terms of issuance. This is happening against a backdrop of excess liquidity in the system. Fed bond buying has

stretched bank reserves to the max, and a liquidity overflow into the Fed's reverse repo window has been the consequence. This is also reflective of an excess of liquidity over collateral, which has pushed market repo rates down to the low single digits. In consequence, the Fed's 5bp on offer at the reverse repo window looks as good as any market alternative.

The elevation of the debt ceiling will at least allow the US Treasury to push some more collateral back into the system. As the Fed tapers to zero in the coming months we will also get to the point where the Fed's bond buying is no longer generating additional excesses of (potential) liquidity. By the end of the first quarter it's likely that the Fed will be near to concluding its taper. After that, the next big focus will be on the delivery of the first hikes in the cycle. That will push the risk-free rate up from mid-2022, similarly impacting repo.

"The situation will morph from one where the Fed is adding to bank reserves, to one where the Fed will be taking bank reserves out"

The significant nuance here is the change from the current situation where the Fed is adding to bank reserves, to one where the Fed will be taking bank reserves out of the system. This will largely be unseen, but ends up pressuring the price of liquidity higher. That will be the precursor to a first hike, and the combination should have an overall tightening effect that will tempt market rates higher generally, and this should be echoed right out the curve.

The eurozone still has a long way to go

2022 is the year EUR rates wake up and smell the coffee. Monetary easing will stop, and tightening is around the corner. This should prove to be a rude awakening with higher rates, wider spreads, and curve movements increasingly dictated by rate hike expectations

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EUR direction: Wake up and smell the coffee

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y EUR swap	0.1%	Higher	0.15%	0.3%	0.45%	0.55%	0.65%

EUR rates face a long road to adjusting to a world of tighter monetary policy. It is hard to blame them, coming out of a decade of below-target inflation, relentless monetary easing, and lower-for-longer interest rates. No more. Our economics team forecasts inflation hovering around the 2% target, admittedly slightly below that level, for the years to come.

"EUR rates face the longest road to adjusting to a world of tighter monetary policy"

Notably, we expect 2023 to start with zero European Central Bank net bond purchases, and with the prospect of a 25bp hike within three months. As this prospect is roughly a year away, it has allowed EUR interest rates to take a more sanguine view of the global inflation groundswell. Some of it is justified by slower price dynamics than in the rest of the world, but tightening steps by other central banks, in particular the Federal Reserve, have the potential to focus minds in EUR markets.

The trajectory we envision for EUR rates is gradually higher, but with the risk of an acceleration when the ECB starts to officially discuss the prospect of rate hikes. The likely tail end of the current Covid-19 wave makes that discussion difficult in 1Q and potentially 2Q, but an early Fed hike would start the countdown to the ECB. The ECB also

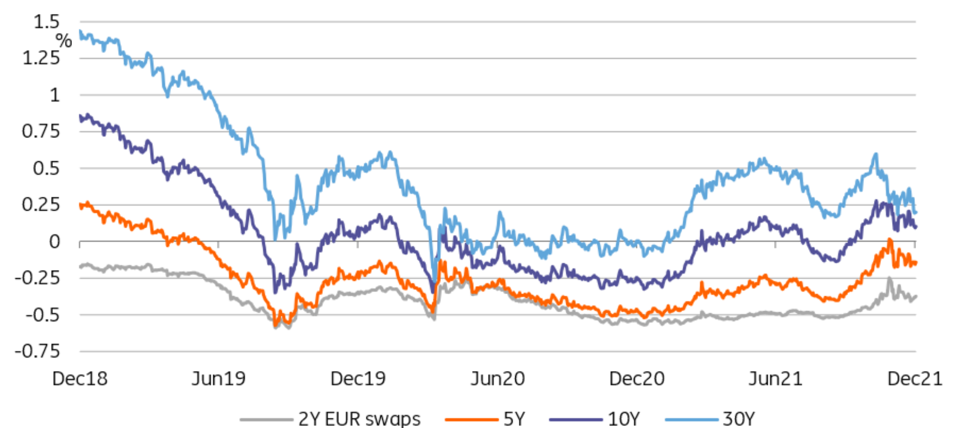
has to go through a tapering of its own. This is complicated by the fact that much of the fixed income market valuation rides on its purchases.

> *"We see ECB hikes as a more potent driver for higher interest rates than tapering"*

Even if tapering is concluded by the end of 2022 as we expect, it will not immediately bring an end to bond scarcity, the fundamental reason for persistently low EUR interest rates. For this reason, and as ECB purchases will, conveniently, only be reduced once the bulk of supply activity is done in 2022, we see ECB hikes as a more potent driver for higher interest rates than tapering.

This should allow 10Y EUR swaps (against 6M Euribor) to climb by roughly 50bp over the course of 2022. This is a non-negligible rise, and it is possible that the first quarter of the year makes this target appear ambitious. We would still think risks are tilted to the upside towards the end of 2022, however, owing to the imminent start of the ECB hiking cycle we're expecting for 2023.

EUR rates have a long way to normalise



Source: Refinitiv, ING

EUR slope: One or two quarters before flipping

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
EUR 2s10s slope	45bp	Steeper	50bp	60bp	70bp	75bp	80bp

We think EUR curve developments stand a chance to escape the monetary tightening steamroller for one more quarter, two at best. This is because the focus in the first months of 2022 is more likely to be on assessing the economic consequences of the winter Covid-19 wave. Instead, primary market activity in bonds and borrowers' rate hedging behaviour should be the dominant drivers. This offers a chance for the EUR curve to continue steepening as borrowers move to take advantage of still low costs at long tenors.

> *"Primary market activity in bonds and borrowers' rate hedging behaviour should be the dominant curve drivers"*

That state of play will persist as long as EUR markets manage to keep their mind off the possibility of imminent ECB hikes. We don't think this will be long, a quarter or two at most. After that, front-end volatility will pick up and the odds of curve flattening will increase.

For an example of what this could look like, look no further than late October/early November 2021. At that time, the EUR OIS curve priced a whole 25bp hike within one

year. It is possible that back then the reaction was magnified by the surprise, but the effect was a sharp flattening of the 2s10s and 10s30s segments. When markets wake up to the possibility of near-term hikes, and remember we expect it to take place in 1Q 2023, then flattening is likely to occur at longer maturities. In our forecast, this translates into 2s10s peaking around 80bp in 2022, before flattening back afterwards.

Meanwhile, the approaching tightening is going to translate into steepening pressure on shorter segments of the curve, for instance on 2s5s. The regime we expect the EUR curve to follow in the second part of 2022 should closely resemble that of the USD curve in most of 2021: with the 5Y sector seeing the most volatility, and with the curve flattening on rates sell-offs beyond that point.

5Y will become the most volatile part of the curve in 2022

Source: Refinitiv, ING

EUR money markets: dealing with tail risks

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
3M Euribor	-0.58%	Higher	-0.55%	-0.55%	-0.55%	-0.55%	-0.50%

Currently, a mix of risk-off sentiment and year-end related factors has pulled front-end rates back from their recent highs. But with the ECB acknowledging the rising risk of inflation being stickier than anticipated, markets could price in the tail risk of higher key rates by the end of next year. Our view is that interest rates will only be raised in 2023, also because of the sequencing that the ECB has to go through when winding down its extraordinary policy support, ending asset purchases first. Yet while we think any ECB hikes priced at the very front-end are unlikely to materialise, rates further out are underestimating the extent and speed of the ECB's adjustment once it decides to alter course.

> *"Pricing of higher rates in 2022 is likely to prove sticky"*

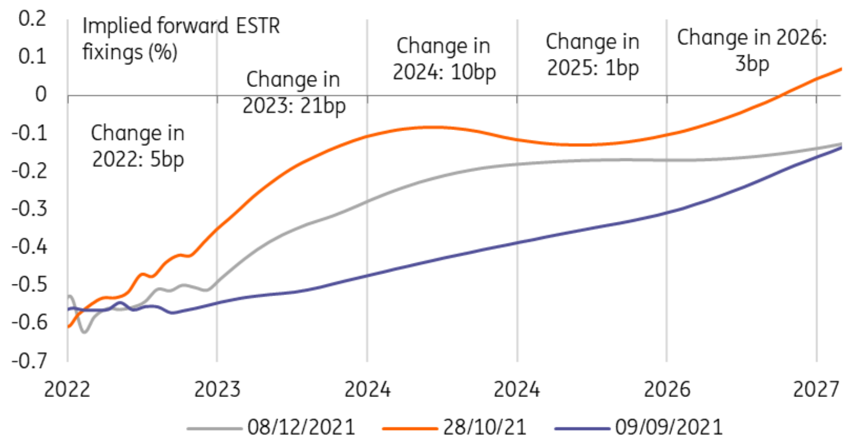
The expiry of preferential terms in mid-2022 under which the ECB provided liquidity to banks via the Targeted Long-Term Refinancing Operations (TLTROs) adds another layer of uncertainty to short term rates. The risk is that banks choose to repay large portions of their drawn amounts, currently more than €2.2t, especially as the TLTROs then no longer mitigate the negative rate costs imposed on banks by the excess liquidity created via the ECB's asset purchases.

"The expiry of preferential TLTRO terms in mid-2022 adds to the uncertainty"

Banks repaying the TLTROs would reduce the amount of excess liquidity, halving it in an extreme scenario, but it would still leave more than €2t sloshing around in the banking system. That should still put enough pressure on the €STR rate to keep it below the deposit facility rate of -0.50%. Nonetheless, banks could be seen to rely more on market funding which could widen funding spreads. In part, that scenario is already reflected in wider forward Euribor-OIS spreads.

That event is still some time off, so the ECB can still afford to wait before addressing the issue. And there are multiple ways the ECB could handle this. One could of course extend the favourable conditions, but further stimulating credit creation when inflationary risks are already increasing is questionable. That leaves the choice of addressing the negative rate costs more directly, via the deposit tiering. The ECB could increase the multiple of required reserves that are exempt from negative rates from currently 6 to 15, a value that would bring the costs to banks down to where they were when the tiered deposit system was first introduced in late 2019.

2022 hike may not materialise, but markets underestimate what comes after



Source: Refinitiv, ING

The GBP curve is ahead of itself

For the GBP curve too, it will be difficult to escape the effects of monetary policy. The start of Bank of England tightening will provide some certainty, allowing long-end rates to recover and steepening the curve somewhat. Tightening should also mean a modicum of credit premia returning to money markets

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Source: Shutterstock

GBP direction: Long-end taking the lead

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y GBP swap	0.7%	Higher	1%	1.2%	1.3%	1.4%	1.4%

There has been a false start but, by all accounts, monetary policy tightening in the UK is going to start any time now. We think in February, and well before the US and eurozone. This will put GBP in a position of greater certainty in 2022 when it comes to the start date and extent of policy tightening.

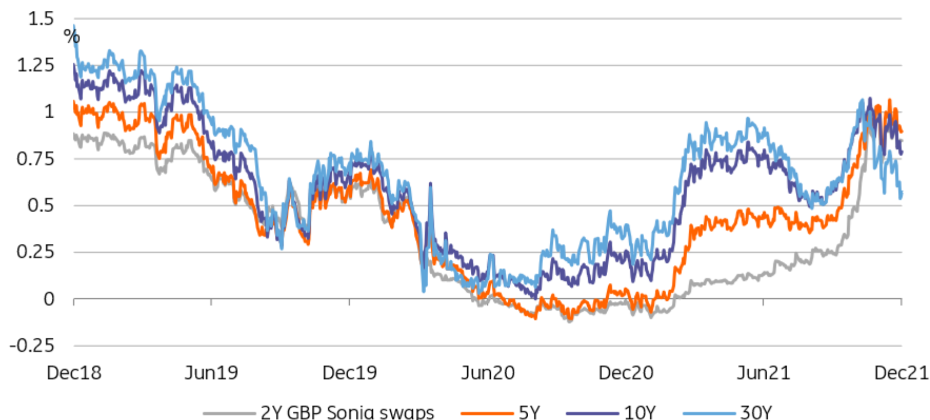
The second factor that sets the GBP market apart is the fact that slightly too much tightening is priced in compared to our own estimate of the terminal rate in this cycle. According to our economics team, Bank Rate could reach 0.75%, conceivably 1% in the second half of 2023. This compares to markets routinely pricing 1.2% by mid-2023. We also find the terminal rate priced by the GBP curve inconsistent with other markets. For instance, the USD curve has routinely priced tightening worth roughly 150bp, while the EUR curve is pricing only in the region of 50bp. This may mean more upside to EUR and USD rates relative to GBP in 2022.

"The front-end was the tail wagging the dog in 2021. 2022 should allow long-end specific factors to regain some influence"

What does this imply for longer-dated GBP rates? The front-end was the tail wagging the dog in 2021. 2022 should allow long-end specific factors to regain some influence but we think this is only likely after the first BoE hike. Our view that the GBP curve is pricing too much tightening implies some mild downside risks to GBP rates. We think this is more likely to happen around BoE policy meetings.

The rest of the time, we expect GBP rates to drift higher alongside their international peers. This will take 10Y GBP swap rates (against Sonia) to 1.4% by the end of 2022. This level is consistent with the peak reached in late 2018 after the final BoE hike (to 0.75%). Upside risk is clear and dominates in our view. It stems mostly from inflation dynamics, as well as impulses from abroad, as the Federal Reserve and European Central Bank take decisive steps towards tightening policy.

The first BoE hike will allow long GBP rates to rise back



Source: Refinitiv, ING

GBP curve: pancake no more

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
GBP 2s10s slope	0bp	Steeper	0bp	10bp	15bp	25bp	25bp

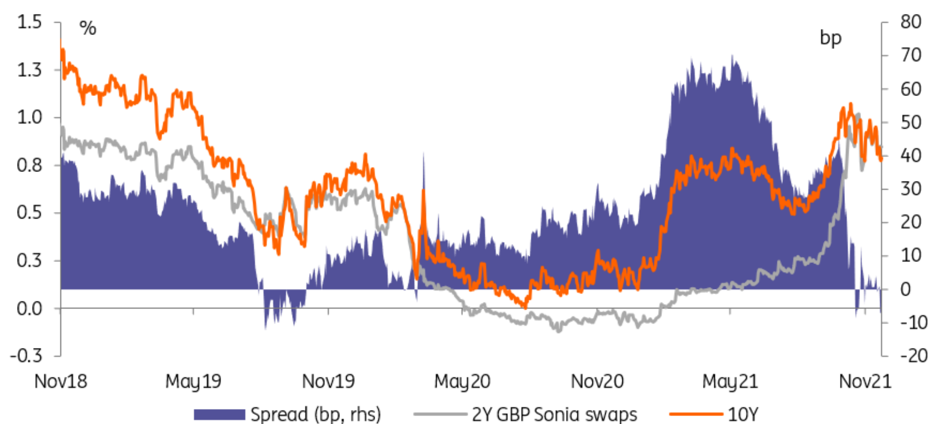
Starting with the overall trend, yield curves typically tend to flatten as the tightening cycle progresses. How early and how fast the flattening occurs depends on the level of the terminal rate and how it compares with the neutral rate for the economy. The latter is an ephemeral economic concept, but it has its use for rates markets. In this instance, we can infer that markets think the terminal rate (roughly 1.2%) is higher than the neutral rate, because the curve is implying that the BoE will subsequently cut rates.

"More realistic BoE expectations mean that the curve will be allowed to re-steepen somewhat"

This is a sign that markets view 115bp of tightening as more than the economy can bear. This is the main reason why the GBP curve flattened so aggressively in 2021 even before the BoE implemented its first hike. This is normally something that occurs much later in a hiking cycle, but BoE communication has led the market to price so aggressive a hiking cycle in 2022 that it would take the Bank Rate above neutral. The winter Covid-19 wave has contributed to the curve pricing a shallow tightening path. More realistic BoE expectations mean that the curve will be allowed to re-steepen somewhat.

In numbers, this means that the 2s10s segment will be allowed to re-steepen to 25bp by the end of 2022. This assumes that the BoE does not tighten policy beyond what the economy can support, and implies that there should still be a residual of term premium causing higher 10Y rates than 2Y rates, even if it is generally accepted that further hikes in the Bank Rate are unlikely beyond 1%.

A flat GBP term structure is no longer needed



Source: Refinitiv, ING

BoE balance sheet reduction, the big shrug

Another interesting aspect of the UK being further along the road to policy tightening is that it should also be one of the first central banks to reduce its balance sheet. The BoE has signalled that it would start passive balance sheet reduction, ie, not reinvesting the proceeds of the gilts that mature in its portfolio, when Bank Rate reaches 0.5%. There is a high likelihood that it does at some point in 2022, after August in our forecast.

There is also the more questionable prospect of active balance sheet reduction, whereby the BoE would actively sell gilts it owns in its portfolio after Bank Rate reaches 1%. We do not assign a high probability to this scenario.

The impact of passive tightening is not easy to quantify, because it is simply the BoE failing to buy gilts in the market. In practice, markets have been very relaxed at the prospect. We think this reflects a number of factors. One is that the impact has been dampened by a reduction in gilts supply announced in October (see supply section). Another is that the policy has been flagged well in advance.

The more profound reason is that markets typically struggle to price events that will take place a long time in advance. If the BoE failing to reinvest the proceeds of its gilt portfolio creates a demand shortfall in future years but there is no demand shortfall at the present, the market will fail to reflect that until the balance between supply and demand actually shifts.

GBP money markets: Coming back to their senses

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
3M Sonia OIS	0.15%	Higher	0.10%	0.2%	0.3%	0.45%	0.55%

The GBP money market (MM) has lost its way during the Covid-19 pandemic. Not only did it fail to price any meaningful credit and liquidity risks, it also has in recent months been in the throes of massive BoE-induced volatility in OIS swaps.

We think a pre-condition for more normal functioning would be for OIS volatility to abate. As we wrote above, we think the start of the BoE cycle will go some way towards providing some stability to the front-end. We would also venture that the market's difficulty in translating the MPC's signal into a hiking path owes in part to the recent

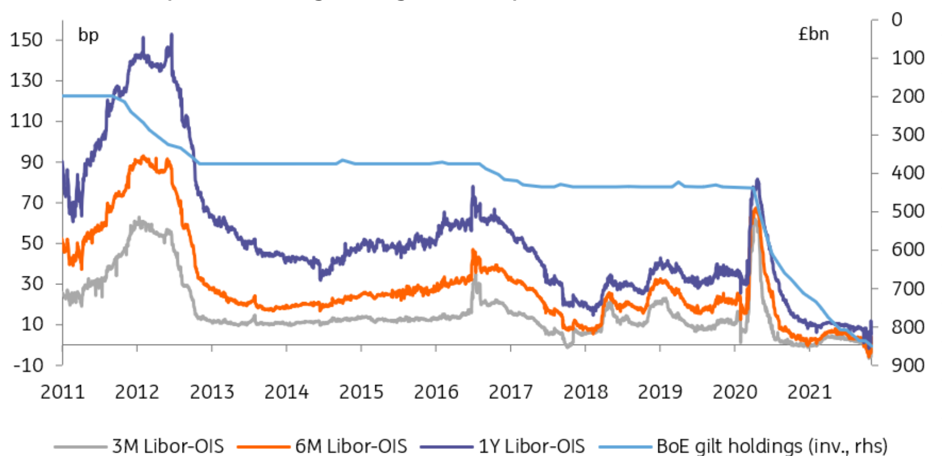
changes at the helm. We find it likely that the most challenging phase of the communication 'training period' is now behind us.

"The BoE is ahead of its peers when it comes to unwinding the policy measures that have contributed to a cratering of MM spreads"

This should set the stage for a recovery in the credit premia, as measured by the spread of commercial paper or Libor over matched-maturity OIS, in GBP money markets over the course of 2022. The BoE is somewhat ahead of its peers when it comes to unwinding the policy measures that have contributed to a cratering of these spreads. For instance, it stopped credit-specific measures long ago (eg, corporate bond and commercial paper purchase), and will be done with net QE purchases by end-2021.

The Bank Rate reaching 0.5% will also usher in an era of balance sheet reduction at the BoE. For the first time, the amount of liquidity, ultimately driving the price of credit in GBP money markets, will decline. This will, presumably, come at the same time as demand for reserves continues to grow. The last part is difficult to measure, and the two will probably catch up much later than 2022, but we expect the prospect to alter the pricing of credit with CP yields trading consistently above OIS.

The BoE will stop steamrolling money market spreads in 2022



Source: Refinitiv, ING

The bond supply dynamic and sovereign spreads

Eurozone net issuance will decline in 2022, but is outweighed by the ECB reducing its footprint. There will be a clear fall in US net issuance in 2022 versus 2021. Crucially, even though the Federal Reserve will stop buying, buying adjusted net supply should actually still feel lighter in 2022. Gilt investors need to absorb more debt as the BoE steps away

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EUR sovereign supply: Moderately lower issuance

We expect gross **European government bond** issuance (EGB) in 2022 to decline only slightly versus 2021. We calculate gross issuance of €1.2t next year versus €1.25t this year as less pandemic related spending is required and economies are recovering. We see net issuance next year falling to €460b from €560b as total redemptions amount to €735b in 2022 versus €667b this year. Taking into account only slightly lower coupon payments, the overall net flow will fall from just above €400b in 2021 to around €310b in 2022.

> *"Issuance should see downward pressure given large cash buffers and Next Generation EU payouts, only partially offset by the desire to term out"*

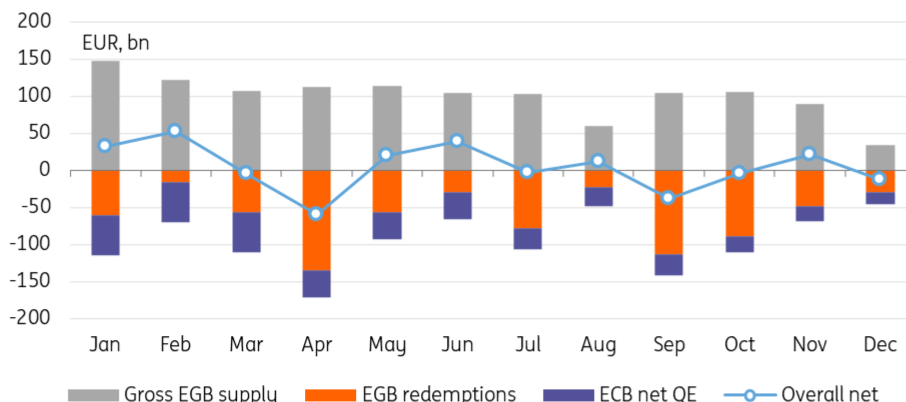
Uncertainty surrounding our forecast remains greater than usual. While most countries, with the notable exception Spain, are facing higher bond redemptions next year, bond issuance should still see downward pressure given, for instance, larger cash buffers and also the incorporation of Next Generation EU payouts into countries' funding mix. That may well be offset in part by an inclination to first reduce or at least term out reliance on shorter-dated funding which had been ramped up at the height of the pandemic.

Also, as of now, the impact of the fourth wave of the pandemic is still unclear. We would suspect that measures are more targeted now and are overall less costly as governments gain more experience in dealing with the crisis. The publication of funding outlooks starting in December may provide more clarity on funding strategies but given the nature of the pandemic, funding needs can remain in flux.

The so-called E-names should see higher issuance next year, mainly as the EU's Next Generation EU funding activities gather steam. The official guidance is for issuance of €150b per year. Add to that minor volumes for the EU's other programmes and perhaps even some residual funding for the EU's SURE programme. On the downside, it is still

unclear whether all the available loans will be handed out. The application period for the loan component runs until 2023. Also still unclear is when recovery plans for Poland and Hungary are approved and under what conditions. The European Financial Stability Facility/European Stability Mechanism will together issue €27.5b, €3b more than last year.

The ECB's QE ensures that net supply to private investors is close to flat



Source: Refinitiv, ING forecast

The ECB remains an important factor to reckon with even as its footprint shrinks. The Pandemic Emergency Purchase Programme (PEPP) is likely to end after March next year - its end possibly smoothed over with a new programme - but the ECB would continue buying via the regular Asset Purchase Programme (APP) at a steady €20b/month pace. In this baseline scenario, we estimate that the ECB could still buy a net €410b of government bonds alone. That is still more than the European government bond net issuance flow of €310b, i.e. issuance minus redemptions and coupons. While rising, the net EGB cash flow to private investors will thus remain negative in 2022. We look for minus €100b, up from an estimated minus €260b this year.

"While rising, the net EGB cash flow to private investors will remain negative in 2022"

There are levers which the ECB may adjust aside from the pure headline volume, such as raising the share of sovereign, supranational and agencies (SSA) purchases. We think there is no need for the ECB to prop up EU issuance at this stage. EGB issuer limits are also of lesser concern now with QE set to slow, leaving little pressure for the ECB to look into SSA purchases instead. More clarity should be provided soon at the 16 December ECB meeting.

EUR sovereign spreads: Peaking in 1Q amid slowing QE and politics

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y Italy-Germany	136bp	Wider	130bp	150bp	130bp	110bp	100bp

The ECB's substantial market interventions via PEPP and the EU's support via the Recovery and Resilience Facility (RRF) have been a boon for sovereign spreads. Still, the past weeks have already shown that the prospect of one of these support pillars being scaled back can have noticeable repercussions, especially at a time when uncertainty over the (global) monetary policy outlook is already increasing market volatility. Our base case view, as illustrated by the spread of 10Y Italian government bonds over Germany, sees spreads peaking in the first quarter of 2022 before gradually retreating towards the lows seen this year. While the ECB's support will remain sizeable (see

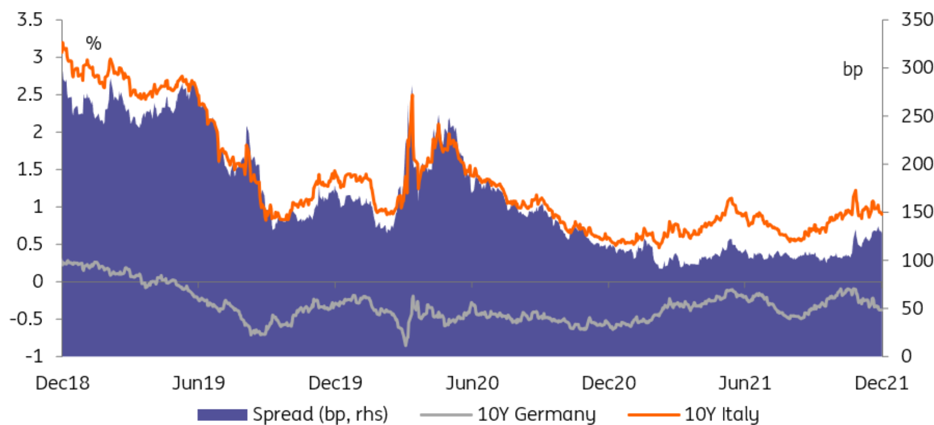
previous section) the extent of any spread recovery will also depend on how much of the PEPP's flexibility, in terms of volumes and country allocation, the ECB will keep on board for the existing or any future buying programmes.

> *"With the ECB's most flexible programme ending and higher market volatility, investors will demand greater compensation for holding higher beta assets"*

The ECB looks intent on bringing PEPP to an end after March next year, but it postponed the decision on what follows until February given uncertainty surrounding the resurgence in the pandemic. Being seen as dovish could help spreads in the very near term, but leaving markets unclear over the next couple of months quickly offsets that benefit. Keep in mind that the start of the year is marked by primary bond markets springing back into action. Technically, this issuance surge is still buffered by the final months of net PEPP purchases as well as the ECB's regular APP. The latter will also continue buying for the foreseeable future ensuring a still respectable overall ECB footprint. However, with the ECB's most flexible programme seen ending and higher "imported" market volatility from global policy tightening, we think investors will demand greater compensation for holding higher beta assets, especially for longer maturity issues.

This may be all the more true as eurozone politics will return to the headlines early in the year with presidential elections in France and Italy. With regards to the periphery in particular, the EU's Recovery and Resilience Facility kept political concerns at bay for much of the past year. More fundamentally, the prospect of reform and substantial investment has bolstered the economic outlook, also manifesting in sovereign rating upgrades. However, these prospects hinge on the timely execution of recovery plans and reforms over the coming years.

Politics will add temporary jolts to waning ECB support



Source: Refinitiv, ING

Italy's presidential election: Setting the stage 2023

Italy's new president will be elected by parliament and regional representatives in January. There is much talk of current Prime Minister Mario Draghi taking over the post from the outgoing President Sergio Mattarella. This would provide markets some reassurance ahead of the general elections in spring 2023 where current polling shows traditionally eurosceptic rightwing parties in a strong position, with the Brothers of Italy at the forefront.

The national unity government formed around PM Draghi has calmed market concerns over Italian politics. As Draghi has been the glue of this technocratic government, leaving this position bears the risk of destabilising it at a critical time

when the implementation of the Recovery Plan is still in its infancy. Early elections cannot be excluded.

An optimal market outcome would be the temporary confirmation of current President Mattarella, leaving him in place until Draghi's current legislature ends in the spring of 2023. Draghi could then oversee the further implementation of the Recovery Plan from the higher level of president. However, Mattarella has so far signalled no desire for this.

French elections: Bye bye Frexit

A repeat of 2017 looks unlikely, but then again, history never repeats itself exactly. Investors will take heart from the fact that no major party, or candidate, has brandished the threat of leaving the EU, or the eurozone. Markets will also cheer President Emmanuel Macron's commanding lead in the first and second voting rounds. Things could get interesting if the traditional (Les Republicains, led by Pécresse) right dilutes support from the incumbent, but the odds of no traditional candidate making it to the run-off are slim.

Inevitable election uncertainty will likely add to sovereign spreads volatility in the first quarter, but the election should quickly fade from investors' minds in favour of the much more important topic of central bank tightening.

USD sovereign supply: Net supply pressure eases significantly in 2022

US Treasury issuance for 2021 will end up at around $5t, the highest ever, bolstered by a fiscal deficit running at about 13.5% of GDP. The fiscal deficit should shrink to below 7% of GDP for 2022 helped by stronger tax revenues. That equates to a net issuance cash need of some $1.75t. On top of that, there is some $2.25t of redemptions to re-finance, bringing overall issuance for 2022 to about $4t, back to around the issuance levels seen in 2020.

Total issuance in the region of $4t for 2022 is still well above issuance levels seen in the immediate pre-pandemic years, which ran at around $2.7t in 2018 for example. Looking forward to 2023, even though the fiscal deficit will shrink further, to a little under 5% of GDP, slightly higher redemptions and a larger cash economy should see the issuance volume fall only slightly, to just below $4t.

"Even though the Fed will stop buying, net supply should still feel lighter in 2022 relative to 2021"

Bottom line, this points to refunding amounts in the area of $1t per refunding quarter for the foreseeable future.

When we focus on net issuance, we find that there is a clear fall from 2021, with net issuance declining by some $1.5t in 2022. Against that, we should factor in the tapering of the Federal Reserve. The Fed is currently buying US Treasuries at an annualised rate of some $1t. In that sense, overall net supply pressure will shrink by some $0.5t, in underlying terms. So even though the Fed stops buying, net supply should still feel lighter in 2022 relative to 2021.

GBP sovereign supply: Higher net impact as BoE steps away

Gross Gilt issuance should fall to £203b in 2022 from £231b this year. The drop in net issuance will be even larger as bond redemptions will double to £98b from £49b. Thus after the net Gilt issuance of £184b this year we should see a drop to £105b in 2022.

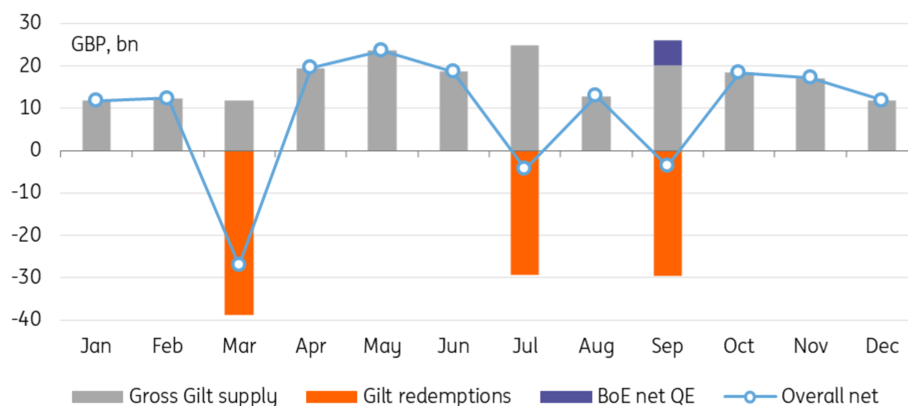
> *"Despite the drop in net issuance, private investors will still have to absorb a significantly higher amount of debt next year"*

However, the BoE has just ended net asset purchases, which means that despite the drop in net issuance, private investors will still have to absorb a significantly higher amount of debt next year. Looking ahead, the BoE has indicated that should Bank Rate reach 0.5%, it will look to start passively running down its holdings by ceasing reinvestments. We think Bank Rate will reach that threshold only late in the summer, meaning that the larger gilt redemptions from the BoE's portfolio earlier in the year should still be reinvested.

BoE gilt holdings should thus shrink by only £6b next year, meaning the net gilt flow to private investors should reach £110b. That, however, is already a significant increase versus this year, where net gilt flows barely reached £14b on the back of the BoE purchasing almost £170b over the course of the year.

At 1%, the BoE has indicated it will begin actively selling bonds from its portfolio. We reckon this will only happen in 2023, if at all.

Net gilt supply will be positive for most of 2022



Source: UK DMO, BOE, ING

Swap spreads to see widening pressure

While there is upward pressure on market rates in 2022, it's not coming from higher net supply. In fact, lower net supply can help to richen government bonds. On top of that, we should see flatter curves over the whole of 2022. We also anticipate some upward pressure on USD Libor. And we expect an overshoot in the spread from eurozone to US rates vs equilibrium

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Source: Shutterstock

US swap spreads with widening pressure in the 10yr

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y USD asw	10bp	Wider	10bp	10bp	10bp	20bp	20bp

There are three factors that should contribute to some widening pressure for US swap spreads.

First, there should be less net supply pressure as we progress through 2022, at least versus 2021. Even when we take account of the end of Federal Reserve buying, there is a reduction in overall net supply pressure, to the tune of $0.5t. This should help to richen government bonds in a relative sense.

"A flatter curve typically correlates with wider swap spreads"

Second, as the Fed hikes rates later in 2022 there should be a clear flattening pressure right along the curve. A flatter curve typically correlates with wider swap spreads on the theory that extensions provide less compensation for spread product, so there is pressure for wider spreads to compensate.

Third, credit conditions are expected to tighten as we progress through 2022. This, in all probability, will place upward pressure on USD Libor rates, reflecting higher required rate prints on financial commercial paper issuance. This should be reflected in upward pressure right along the USD Libor curve.

This also correlates with upward pressure on 3-month USD Libor rates versus 3-month SOFR as we progress through 2022.

EUR swap spreads: scarce bonds and growing liabilities fixing

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y German asw	49bp	Neutral	45bp	45bp	45bp	45bp	45bp

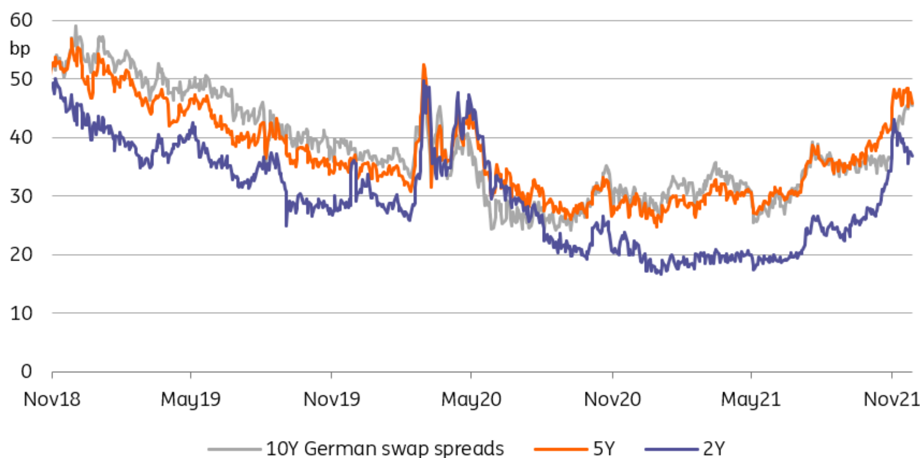
Swap spreads aren't necessarily the area where one would expect central bank tightening expectations to be the most clearly priced in. In theory, this leaves them free to reflect the usual technical factors that normally affect the differential between swap rates and government bonds. This is only true up to a point.

The reduction in ECB excess liquidity should strengthen expectations of wider Euribor-OIS spreads. This could in theory be offset by the cheapening of government bonds as year-end distortions ease and as the ECB tapers its purchase programmes. In reality, we expect bond scarcity to remain largely prevalent throughout 2022 with no meaningful ability to impact swap spreads with a durable effect, save for a knee-jerk cheapening in early January as bank balance sheet constraints ease.

"Bond scarcity has boosted the directionality of short-end swap spreads and we expect this dynamic to spread to longer tenors"

Investors hedging behaviour will gain in importance as 2022 progresses. Bond scarcity has boosted the directionality of short-end swap spreads (widening on greater hike expectations) and we expect this dynamic to progressively spread to longer tenors as borrowers increasingly see the appeal of fixings their liabilities. This factor is the hardest to quantify as it mostly depends on whether and when the reality of higher rates dawns on market participants but, as the year progresses, we expect the consensus to move in that direction, keeping swap spreads at wider levels than in the past year.

Demand to fix liabilities will keep EUR swap spreads wide



Source: Refinitiv, ING

US versus Euro market rates: Widening pressure

Room should be made for hikes through 2022, with the US 10yr pivoting higher first in the first quarter. The current spread from the Euro 10yr to the US 10yr is 145bp. We expect this to stretch to 175bp as the US macro story and forward rate hike narrative leads the eurozone one.

From the second quarter, front end rates in both the US and eurozone should come under upward pressure, re-flattening curves. As this will be led by the US 2yr, its spread versus the eurozone 2yr should come under widening pressure. The current eurozone to US 2yr spread is 120bp. We can see this stretching to the 200bp area.

"Both the 2yr and 10yr spreads between the eurozone and the US will find a more natural equilibrium in the 150bp area"

Both the 2yr and 10yr spreads between the eurozone and the US will find a more natural equilibrium in the 150bp area, which by extension points to the above widening targets as overshoots. This 150bp valuation is not overly stretched as we'd continue to identify a buying/receiving pressure on US rates reflecting their relative elevation versus comparables.

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