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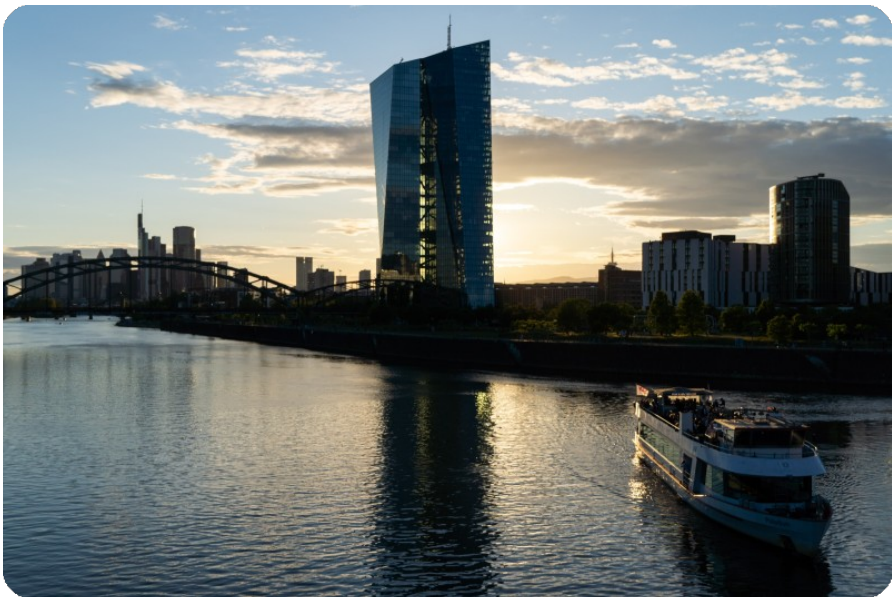
RATES SPARK

Rates Spark: Oil back above $100

We think the ECB will hike rates, but the path thereafter remains open. Oil breaching $100 and record gas prices year-to-date add to the complexity. With markets already pricing in a very hawkish outlook, we still think a dovish surprise from the ECB is more likely. Nervousness about fiscal trajectories in the eurozone also supports a dovish ECB bias



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The $100 threshold has been passed and markets are quick to price in more hawkish central banks

The European Central Bank is widely expected to raise its policy rates today by 25bp, which would take the deposit facility rate to 2.5%. This is a level which is widely regarded as marking the upper end of what is considered the neutral policy rate range.

Markets are not only fully discounting today's move already, they are also eyeing further tightening beyond September of more than 50bp, taking the deposit facility rate to at least 3%. This comes, of course, on the back of oil prices topping US$100/bl and also gas prices marching higher amid geopolitical tensions flaring up again. Markets are still following a similar playbook whereby every move in oil is immediately captured by a predictable move in the 2Y rate. But with gas prices now higher than before, we could imagine markets starting to pay more attention to developments in gas too.

It also highlights the challenge for the ECB. Not only will the ECB's new forecasts already be based on outdated market snapshots, but it also makes any guidance around a future path difficult. The default in such an uncertain environment is to stick to meeting-by-meeting guidance.

Given that the market is already priced very aggressively, we struggle to see how the ECB could push markets even further in that direction. While risks of second-round inflation effects are rising with the duration of the conflict, by the ECB's own account, those effects have not been observed yet. And if anything, markets' aggressive stance and rising market rates also in the longer tenors are helping to tighten financial conditions.

Geopolitical tensions are pushing eurozone government bond spreads wider, while growing market concerns about debt sustainability could also stop the ECB from sounding too hawkish. As France has moved into focus, given the added layer of political uncertainty, we now see that 10y OAT swap spreads have become more closely correlated and sensitive to oil prices than Italian bonds. The latter had long proven to be the most exposed to geopolitical risk, not least given a larger reliance on energy imports from the crisis region in the beginning.

US Treasury buyback announcements garner a strange reaction

There's been a strange reaction to the tripling in the buyback amounts announced by the US Treasury. Long-end yields rose. Yet it was more than a doubling; it was a tripling. Of course, we won't know what they actually do until they do it, but they intend to do $6bn, up from $2bn per event. Based on that alone, the gap higher in long-end yields does not make much sense, unless the market had been expecting a quadrupling or more and/or a much bigger statement. We are not sure that was necessarily the case.

What is even stranger is the minimal reaction in swap spreads. They widened by a smidgen. But if the market was genuinely disappointed with the buyback size, they should have widened by much more, i.e. Treasury yields should have risen by more than SOFR rates. In that sense, it's a really unusual reaction, where long end SOFR rates are up, swap spreads unchanged, and long-end Treasury yields are up too. SOFR rates, it seems, have been pulled up by Treasury yields, but for no good reason.

My main contention is that the best Bessent can do is richen long tenor Treasury yields versus long tenor SOFR rates, in other words, to tighten long-end swap spreads. Since the original buyback announcement, this has been successful, in the sense that the 30yr swap spread is tighter by some 8bp since the buyback announcement. Bessent can't control long-end SOFR, as the 10yr SOFR rate, for example, is nothing more than a rate that breaks even against the expected profile for floating SOFR into the future. That's tough to affect through just buybacks! And certainly not in the relatively small size being deployed so far.

It's early days, and we'll see where this goes. But in a sense, markets may be telegraphing to

Bessent that it will be tough for him to have meaningful control over long-end rates.

Thursday's events and market view

The ECB interest rate decision and press conference will be the key event of the day. In data, the focus is shifting towards the US already ahead of Friday's likely policy-defining CPI release. With an eye on inflationary pressures, Thursday will see the publication of the August PPI, where a 0.4% month-on-month increase is expected. We will also get the US weekly jobless claims numbers.

Primary markets will see Italy auctioning 3y, 7y and 45y bonds for up to €7.75bn. The UK auctions new 4y gilts (£5bn). Over in the US, the Treasury will sell US$22bn in 30y bonds and buy back US$6bn in 10-20y bonds.

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