Central bank watcher

Work in progress

- Fed: taking lessons from the 70s
- ECB: far away
- PBoC: contrarian course continues
- BoJ: the big flattening

It's work in progress for central banks. But the meaning of this phrase differs depending on the bank in question. For the Fed it means taking policy rates another big step towards restrictive territory. The ECB seems to be edging in a similar direction, with the clear acknowledgement at their September policy meeting of the need to raise rates much further. For these central banks, one of the key questions is whether the neutral rate – the point at which policy becomes restrictive – has increased. Financial markets will probably give a verdict on this matter, with flat or inverted yield curves already hinting at a restrictive policy stance.

For the PBoC, 'work in progress' means managing the economic impact from a declining property market and Covid outbreaks, while trying to prevent the manifestation of higher inflation that is visible elsewhere. We still think further easing in China is more probable than tightening. In the case of the BoJ we see only incremental progress towards a change in policy stance. Underlying inflation drivers simply have not moved much. But with pressure building on the JPY, we do expect some changes to their yield curve control policy. Work in progress indeed.

Article
For professional investors
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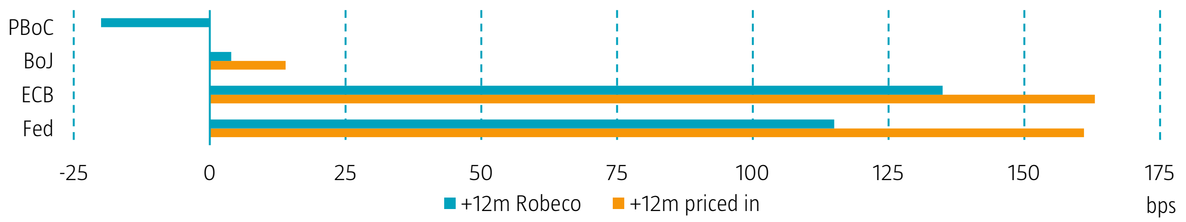
Global Macro Team
Martin van Vliet
Rikkert Scholten
Bob Stoutjesdijk

Outlook for central bank policy rates



Source: Bloomberg, Robeco, change 12m ahead, based on money market futures and forwards; 12 September 2022

The Federal Reserve: taking lessons from the 70s

- Fed committed to tightening further
- Market response probably key in timing the final hike
- Second-to-last rate hike seen as an important buying signal

More to do

The Fed is committed to bringing down inflation and preventing an anchoring of inflation expectations at a high level. While long-term consumer inflation views have remained quite stable, short-term expectations have risen materially. The longer people are confronted with steep price increases, the more likely it is that they will incorporate high price expectations into their decisions. Powell called this "rationalizing" in his Jackson Hole speech. Without intervention to cool prices, this could result in a long-lasting feedback loop between high inflation and wages. Preventing such a wage-price spiral comes with much lower costs than breaking it once it has been established. This has been the dominant narrative among Fed officials in recent months.

It is probably also relevant for Fed policy that the *nature* of inflation has been changing. Domestic factors, such as the overheated labor market and high rental inflation have become more important. The expectation that monetary policy can make a meaningful difference in influencing these inflation drivers probably makes it easier for Fed officials to commit to restrictive policy.

Search for neutral rates level is getting relevant

With rates at current levels, an increasingly apt question is at what point rates will become restrictive. In the July meeting Powell made a reference to the neutral rate being around 2.5%. He based this conclusion on the median "longer-run dot" in the June Summary of Economic Projections (SEP). But the neutral rate is not static. While 2.5% may be neutral longer term, in current conditions the level from which rates start cooling the economy could be higher. This makes the longer-run dot in the SEP of the 21 September FOMC meeting quite important. We expect it to move up, but if the rise is limited to 2.75% it will have modest implications. A rise towards 3.0% or higher would be meaningful. This would imply that, in order to be restrictive, the peak rate in this cycle would be some distance from the 3.0% level.

What is priced in for the Fed, versus our expectation

Effective Fed funds rate	2.33	Sep-22	Dec-22	Mar-23	Jun-23
Change implied by FF Futures (bps)		72	154	167	161
Our probably-weighted expectation (bps)		74	135	140	115
Our central scenario (bps)		75	125	125	125

Source: Bloomberg, Robeco; 12 September 2022

Three routes toward an end to tightening

For the September FOMC meeting we expect a rate hike of 75 bps and our base case is for another 50 bps hike in November. That would take the fed funds rate to 3.5-3.75% The potential and desire to hike beyond that level would probably depend on three developments:

1. Whether inflation turns convincingly. This matters most for the sticky elements such as rents and other services.
2. To what extent the labor market cools.
3. Whether broader financial conditions tighten enough, via credit spreads, equity prices, long-term rates and dollar strength, among others.

The ideal scenario for risk assets would be a turn in inflation. US gasoline prices have fallen more than 20% since June and used-car prices have started to come down as well, but so far the sticky elements of inflation have shown little sign of bending. The labor market seems to be cooling a bit and the Fed will welcome the recent rise in participation. But the jobs market will probably remain overheated for a while. This makes the third factor the most likely driver of Fed policy after September. If risk assets sell off in response to Fed tightening we will probably see the last hike in November. If the hikes are well received, the Fed may be moved to continue hiking until it hurts. Risks are tilted towards a longer hiking cycle, which is why our weighted-average expectation for the fed funds rate is somewhat above our base case. We don't expect any changes in QT in the coming quarters. From the Treasury side, we would mainly expect larger bill issuance, with stable coupon supply. QT may start to play a role in determining future rate steps from the fourth quarter onwards. But it is too early for that now.

It remains to be seen whether the US economy will be able to deal with much tighter policy. Getting policy right is a near impossible task in 'normal' tightening cycles, but with inflation now at decade highs, it is even tougher this time. In addition, there have been several examples where the 'Powell Fed' has found it difficult to read market signals, while the departure of Richard Clarida has left a gap in forward-looking policy thinking. Our base case is for overtightening and a further negative response in risk assets. This will probably force the Fed to ease policy at an earlier date than currently anticipated. This is the reason for the downward tilt in our projections for official rates in mid-2023.

USTs	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	3.54	3.55	181	63
5yr	3.41	3.36	67	17
10yr	3.29	3.36	38	12
30yr	3.44	3.43	16	4

* for a 1pd position over 12 months

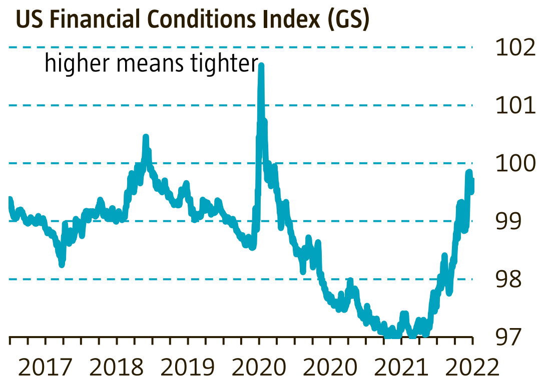
Source: Bloomberg, Robeco; 12 September 2022

Building steepeners while waiting for that second-to-last hike

New highs in rates have been set at the front end of the curve, but the back end has so far failed to break the June levels. At this stage of the tightening cycle, expectations for the fed funds rate two years out tend to have a large impact on longer-term rates. As the shorter-term risks remain tilted towards pricing in higher official rates, we also see the risk for the belly of the curve as being skewed towards the upside. Rates usually anticipate on the last hike in the cycle, turning in the weeks before. This makes the timing of the second-to-last rate hike very relevant for duration positioning. September could be this meeting, but it would be the earliest possible date. On the curve we prefer using significant flattening moves as entry points for building a steepener position in 2-10yrs or 5-10yrs. We think 10-30yrs will continue to trade in a 0-30 bps range, potentially offering tactical opportunities.

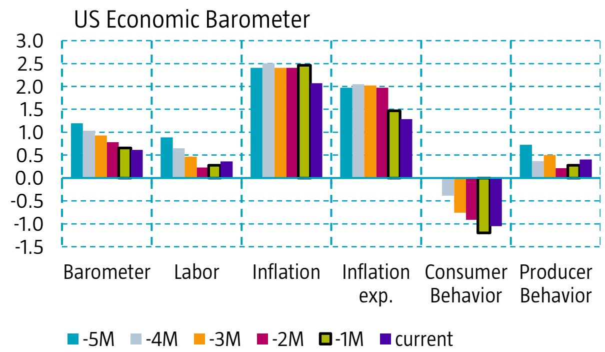
US labor market data have started to moderate from very strong levels. Consumer confidence and spending have slowed, while producer confidence remains quite strong. Breakeven inflation rates have fallen, following oil prices.

Chart 1. Tightening of US financial conditions continues



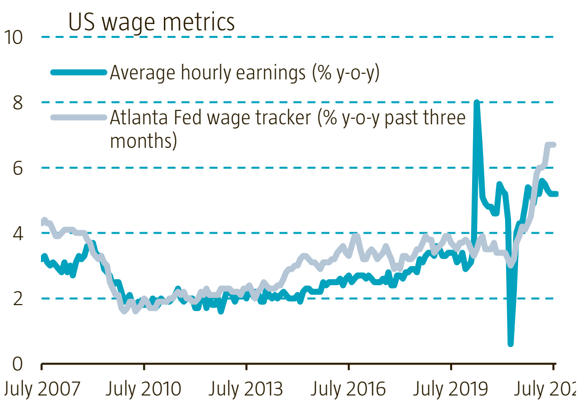
Source: Robeco, Goldman Sachs, Bloomberg; 12 September 2022

Chart 2. Barometer slows further



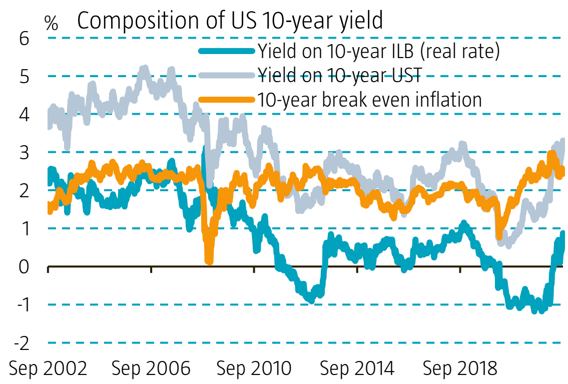
Source: Robeco, Bloomberg; 12 September 2022

Chart 3. Some divergence in wage metrics



Source: Robeco, Bloomberg; 12 September 2022

Chart 4. US real 10-year rates have risen 1.8pp from their lows



Source: Robeco, Bloomberg; 12 September 2022

European Central Bank: far away

- Lagarde signals policy rate peak is still "far away", but could be reached by February
- We second-guess the market's assumption the depo rate will stay well above 2% in coming years
- Still biased to flatter curves and tighter swap spreads, with lingering collateral scarcity remaining a risk

A higher peak, possibly, but not a plateau
Broadening and strengthening inflation pressures prompted the ECB Governing Council to hike policy rates by 75 bps at the September meeting, bringing the deposit facility rate to 0.75%, the highest level since mid-2011. Importantly, the statement noted the ECB expects to raise rates further over the next several meetings "to dampen demand and guard against the risk of a persistent upward shift in inflation expectations". During the press conference President Lagarde specified that "several meetings" was meant to refer to 2-3 meetings. This implies the hiking cycle could end at the December or February 2023 meeting. However, Lagarde also said that the policy rate was still "far away" from its upcoming peak, implying that further increments of more than 25 bps beckon.

Separately, to ensure that the move transmits to money market rates, the ECB decided to suspend the two-tier system for the remuneration of banks' excess reserves – meaning they will get paid the depo rate on their full excess liquidity holdings at the central bank. Going into the meeting, market participants had feared that a chunk of banks' liquidity holdings might stay remunerated at 0% – causing T-bill yields and repo rates recently to lag further behind the rise in shorter-dated swap rates. The latter was also due to fears the 0% interest rate ceiling on government deposits held at the ECB (currently ~EUR 500bn) would be maintained. Instead, this has been removed temporarily. While it is encouraging that the ECB is aware of the signs of collateral scarcity in repo markets and that it is keen to "preserve the effectiveness of monetary policy transmission", the risk of renewed relative outperformance of Bills and repo rates later this year has not vanished.

What would ultimately address scarcity, besides making borrowing of German collateral via securities lending less expensive, is if the ECB were to stop fully reinvesting their QE holdings. However, for now, the central bank seeks to continue reinvesting the principal payments from maturing securities "until at least the end of 2024" (i.e. for PEPP redemptions) or "for an extended period of time past the date when it starts raising policy rates" (for those under the APP). Even so, discussions on quantitative tightening (QT) will likely start at the next meeting, in October.

Given the outlook for inflation to remain close to or above 9% over the remainder of the year, we understand why financial markets are pricing in almost 150 bps of rate hikes for the next three meetings (see table below). Looking beyond the next 6-12 months, however, we second-guess the market's assumption that the depo rate will stay (well) above 2% (Chart 1). Indeed, we doubt that all Eurozone economies can structurally handle such tighter nominal financing conditions (Chart 2), especially given the darkening cyclical growth picture.

What is priced in for the ECB versus our expectations

ECB deposit facility rate	*0.75*	Dec-22	Mar-23	Jun-23	Sep-23
Change implied by OIS (bps)		116	156	163	165
Our probability-weighted expectation (bps)		110	140	135	135
Our central scenario (bps)		100	125	125	125

Source: Bloomberg, Robeco; 9 September 2022

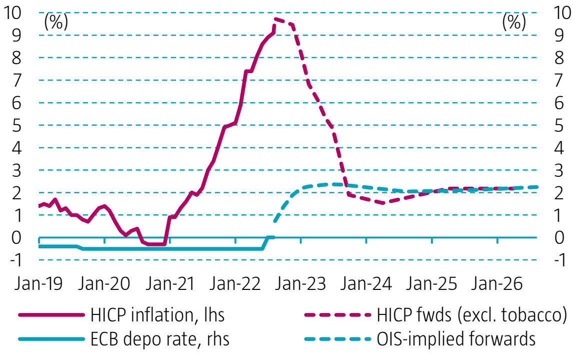
DBR curve	Spot yield	12m Fwd	Carry* (bp)
2y	1.31	1.40	63
5y	1.55	1.60	32
10y	1.69	1.81	22
30y	1.79	1.81	6

* for a 1pd position in cash bonds over 12 months
Source: Bloomberg, Robeco; 9 September 2022

Still biased to flatter curves and tighter swap spreads, with lingering collateral scarcity remaining a risk

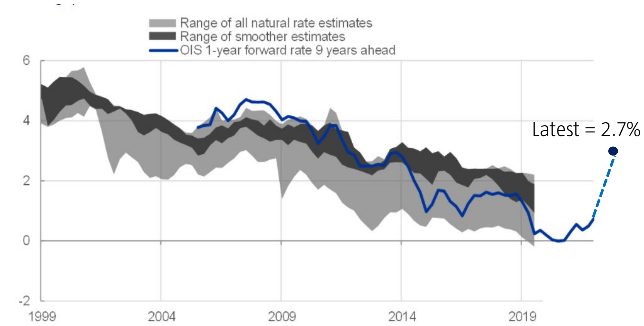
- German 10-year government bond yields dropped sharply from their June peak during the summer, but this has nearly fully reversed since then. The renewed rise has been driven mainly by an upgrade of policy rate expectations – markets are now pricing in an ECB depo rate peak in the coming cycle of above 2.25%. However, the term premium component also bounced higher (Chart 3), in line with the rise in 10-year UST yields.
- As suggested before, while we acknowledge the possibility the ECB might need to hike rates to well above 2% this cycle, we struggle to believe the ECB will be able to keep them there. Indeed, at close to 2.75%, the EUR 1-year OIS rate 9-year forward – assuming term premium and OIS-policy rate wedge adjustments cancel each other out – clearly exceeds the range of ECB estimates of the long-term 'neutral' depo rate (Chart 2). This makes us reluctant to suggest underweight positions in the 10-year area, certainly in swaps. Note that *real* 10-year OIS rates are also hovering near the upper end of their 10-year historical range (Chart 4).
- While valuations thus hint at turning more constructive on long-end EUR duration, we refrain from advising a *large* outright overweight position just yet. This is because we think that, given the elevated near-term inflation profile, markets will be slow to price in lower implied policy rates in the 5 to 10-year part of the curve despite the bleak growth outlook. We keep a flattening bias on the 2s10s curve; the risk is that further UST-led rises in 10yr yields could drag the EUR 1-year OIS rate 9-year forward even more out of sync with long-term 'neutral'.
- As for German swap spreads, we retain a strategic tightening bias, assuming a supply and QT-driven easing in collateral scarcity, and a drying-up of swap-paying flows. But we acknowledge that increased recession risks and a renewed scramble for collateral in Q4 might imply that swap-spread tightening – certainly in 2-year space – takes longer to materialize.

Chart 1. Market's ECB policy rate and inflation forwards



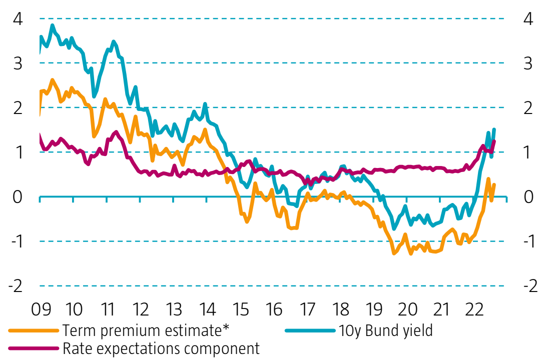
Source: Bloomberg, Robeco; 9 September 2022

Chart 2. Market embraces new long term neutral rate regime



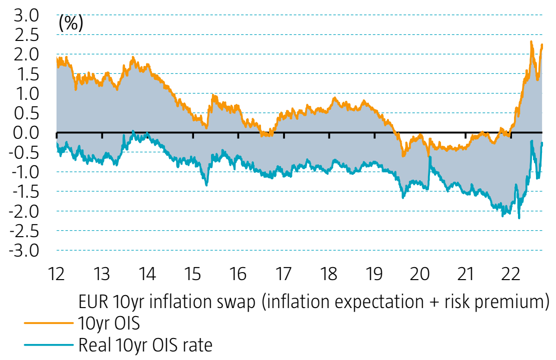
Source: Bloomberg, ECB, Robeco; 9 September 2022

Chart 3. Term premium



Source: Bloomberg, Robeco; 9 September 2022 * estimates based on Fed ACM model; special thanks to our colleague Roderick Molenaar

Chart 4. Nominal and real 10yr OIS rates



Source: Bloomberg, Robeco; 9 September 2022

People's Bank of China: contrarian course continues

- Growth still held back by Covid outbreaks and property weakness
- Maintaining an easing bias in our policy outlook
- We would use any further, front-end-led curve steepening to shift into flattening positions

Remaining constructive on 10-year CGBs

China's zero-Covid strategy continues to hold back its economic growth. It is not just the waves of lockdowns and other restrictions that are hurting economic activity; the lingering uncertainty about future outbreaks continue to dampen business investment and consumer spending. The weakness in the country's main growth engine over the past decade, property, also persists. Indeed, despite massive easing efforts by local governments in particular, housing demand struggles to revive.

The main channel through which economic growth *is* being supported is infrastructure investment. The latest State Council Meeting, on 24 August, called for an additional RMB 300bn (~0.3% of GDP) in credit support by policy banks, aimed at further buttressing the infra engine. But our opinion is that this will not be enough to ensure average growth reaches close to 5.5% in 2022 – a target the consensus also no longer sees as achievable. To be sure, China's closely watched 'credit impulse' is no longer in negative territory (Chart 3), perhaps offering some support for global growth in early 2023, although one could argue that the quality of lending – rather than the quantity – may matter more here. Moreover, thus far the impulse remains well below levels seen after the slump in 2012 and 2015.

While growth remains fragile, as corroborated by our Economic Barometer (Chart 2), headline inflation has risen, mainly on the back of an increase in pork and other food price inflation. Even so, underlying inflation pressures have remained muted, with the core rate hovering below 1%.

Against the above backdrop, the PBoC decided to cut the 7-day reverse repo and 1-year MLF rate by 10 bps in mid-August. This had little impact on money market rates, though, which were already hovering well below the policy corridor due to the loose liquidity situation (Chart 1). But it did allow banks to lower the LPR rates later last month – i.e. the 1y LPR by 5 bps and the 5yr LPR, more relevant for mortgage loans, by 15 bps. With the latest central bank rhetoric suggesting that the PBoC has room to adjust monetary policy, we are inclined to keep an easing bias in our outlook for China policy rates, contrary to financial markets (see table below). That said, we also ascribe a decent probability to a scenario where the PBoC tries to sit it out and keeps policy rates unchanged over coming months, until growth worries cause it to resort to an RRR cut, even if – as we expect – food prices push up headline inflation somewhat further.

What is priced in for the PBoC versus our expectations

PBoC 7-day reverse repo	*2.00*	Dec-22	Mar-23	Jun-23	Sep-23
Change implied by forwards (bps)		0	0	0	0
Our probability-weighted expectation (bps)		-5	-13	-20	-20
Our central scenario (bps)		0	-10	-15	-15

Source: Bloomberg, Robeco; 9 September 2022

Following the policy rate cut on 15 August, 10-year CGB yields broke below the 2.75-2.85% range seen since February, and now hover slightly above 2.60% – i.e. around 70 bps through 10-year Treasuries, the most since 2009. With no sign of a significant change to either the Covid strategy or the property outlook, the risk of a sharp rise in 10-year CGB yields seems contained over coming months. At the same time, although we keep an easing bias in our outlook for policy rates, we find money market rates up to 12 months already trading well through the PBoC's 7-day reverse repo rate. Accordingly, while factoring in the plausibility of higher headline inflation, we would use any further, front-end-led curve steepening to shift into flattening positions. Looking beyond the coming 6-12 months, we continue to believe that the elevated overall indebtedness and China's demographic outlook will require lower equilibrium policy rates, which should translate into further cross-market outperformance of CGBs over the coming years.

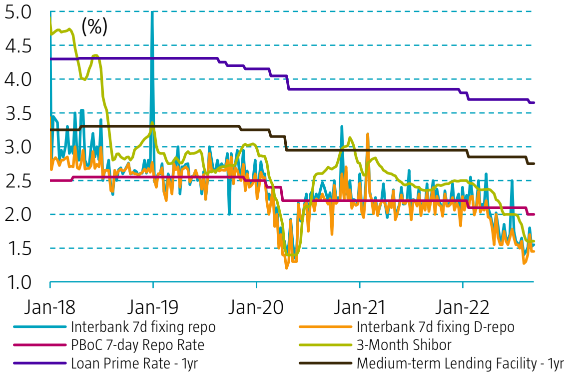
CGB curve	Spot	12m Fw
2yr	2.02	2.39
5yr	2.38	2.66
10yr	2.62	2.81

Source: Bloomberg, Robeco; 9 September 2022

Economic barometer struggles to improve

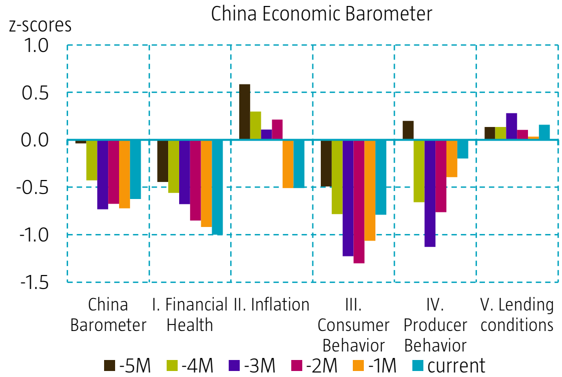
- Our economic barometer for China has remained in negative territory in recent months, albeit no longer falling (Chart 2). This is mainly driven by the producer-behavior component and reflects the bounce in rail freight traffic, electricity consumption and the PMI new orders index.
- The consumer component has also nudged higher on the back of a sharp, partly policy-related, pick-up in car sales and somewhat higher PMI employment readings. But still-sluggish housing sales and a very weak marginal-propensity-to-consume metric (based on household demand deposits relative to savings deposits) continue to exert a significant drag on the consumer behavior Z score.
- One relative bright spot remains the Z score for 'lending conditions', which comprises, among others, the closely watched credit 'impulse' metric – which factors in the flow of credit relative to GDP and has moved out of negative territory. The pick-up in M2 growth has helped here as well. Meanwhile, the overall Z score for 'inflation' has dipped into negative territory, thanks to the slowdown in PPI and non-food CPI inflation.

Chart 1. Selected policy and money market rates



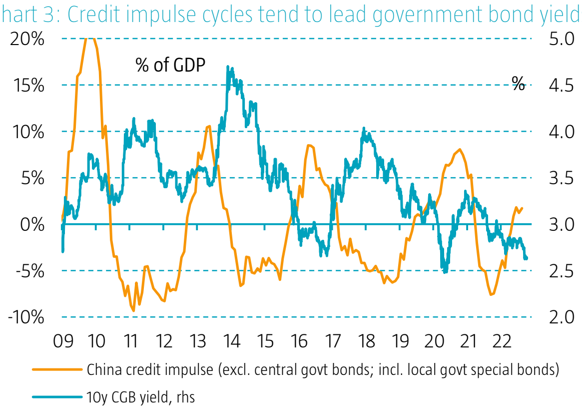
Source: Bloomberg, Robeco; 9 September 2022

Chart 2: Barometer struggles to improve



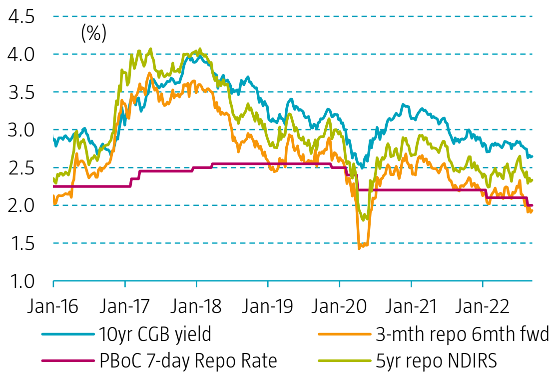
Source: Bloomberg, Robeco; 9 September 2022

Chart 3: Credit impulse cycles tend to lead government bond yields



Source: Bloomberg, Robeco; 9 September 2022

Chart 4: Selected short-term and long-term rates



Source: Bloomberg, Robeco; 9 September 2022

Bank of Japan: the big flattening

- Policy differential
- Yen weakness
- Long-end yields to fall

Policy differential

The BoJ remains the largest outlier in the world of developed market central banks. It continues to diverge from its G10 counterparts by sustaining a dovish bias to keep inflation expectations alive, and by underpinning the economy with the aim of stabilizing and sustaining inflation. In particular, the BoJ has maintained that it will continue easing until wages and prices show a stable and sustainable increase. This stance might be interpreted as targeting wages. It also suggests the BoJ will keep its accommodative leaning until it sees the results of this winter's bonuses and next spring's annual wage negotiation, to determine whether nominal wages do continue to rise and real wages do pull out of negative territory.

To a certain degree the BoJ's relatively dovish approach is justified. Many of the inflationary pressures from food and energy are being counteracted via fiscal policy (petrol subsidies, for example) keeping inflation relatively low, at around 3%. Furthermore, the growth picture is more complicated in Japan compared to its G10 counterparts. Covid continues to have an impact on economic activity, while the dampening effects of the global growth slowdown on its manufacturing sector is becoming evident. From that perspective we consider it unlikely that the BoJ would move hastily to normalize policy, including introducing any changes to its forward guidance that would neutralize its easing bias, until the 2% price-stability target is reached in a stable and sustainable manner.

Yen weakness

In the context of this policy divergence – the BoJ's easy monetary policy compared to the tightening of its global counterparts – the yen remains weak. Another wave of strong rhetoric from the Ministry of Finance (MoF) and other government officials in response to the yen reaching a 40-year low triggered increased speculation that exchange rate intervention is imminent. But we think market intervention is unlikely in the near term. First, yen weakness is fully explained by Japan's terms-of-trade shock. Secondly, to successfully stabilize the yen, global coordination is needed, which in turn requires it to be a financial emergency – which it is not. Still, the more the yen weakens, the stronger the speculation will be about possible currency interventions by the MoF and a potential BoJ U-turn on monetary policy. Perhaps against expectation, the BoJ has remained largely silent on the yen, which is likely out of consideration for the potential market impact of such an assessment (the risk of fueling market expectations of a policy change).

We think it is becoming more difficult for the BoJ to stick to its constructive view of JPY weakness without an explicit assessment of how the likely impact on medium-term inflation could be mitigated. But, as our above-mentioned observations show, it is still too early to effectively act on those concerns. For the policymaker to act in the near-term would probably require an unanchoring of inflation expectations or signs of stress in Japanese financial markets. Neither of these is evident yet. We therefore expect the BoJ to stick to its easing bias at the next BoJ meeting, in September. As long as G10 central banks stay in tightening mode and the yen keeps falling, it will become increasingly difficult for the BoJ to maintain this stance, though. We therefore expect some changes to YCC policy, through a widening of the bandwidth in the October and December meetings.

What is priced in for the BoJ, versus our expectation

Policy balance rate	*-0.10*	Dec-22	Mar-23	Jun-23	Sep-23
Change implied by futures (bps)		1	4	10	10
Our probability-weighted expectation (bps)		0	0	1	2
Our central scenario (bps)		0	0	0	0

Source: Bloomberg, Robeco; 12 September 2022

Long-end yields to fall

Long-end yields have risen a lot in recent quarters. In similar episodes in the past when long-end yields increased strongly and the BoJ judged that there was an increasing risk that the 0.25% cap of the YCC target would be breached, it inhibited that rise by increasing ordinary operations and conducting unplanned operations even in the over-10y sector. Some market participants may think the BoJ will be cautious this time in suppressing yield rises due to the impact it would have on the JPY. As long as the BoJ sticks to YCC, it will continue to face a trilemma of simultaneously needing to achieve monetary policy independence, exchange rate stability and capital mobility. This could keep the depreciation bias of the JPY in play as long as other G10 central banks keep tightening policy. However, given that the BoJ does not target exchange rates explicitly when conducting monetary policy, as repeatedly pointed out by Governor Kuroda, and given that the objective of the current YCC is to keep long-term yields under control to support economic growth, we expect that the BoJ will continue to use its operations to suppress rises in long-end interest rates. It has been doing so for the past months with a clear focus on the 5yr and 10yr points, but we expect them also to explicitly target the 20yr and 30yr points. The latter points are starting to become more relevant given that growth in Japan is weakening.

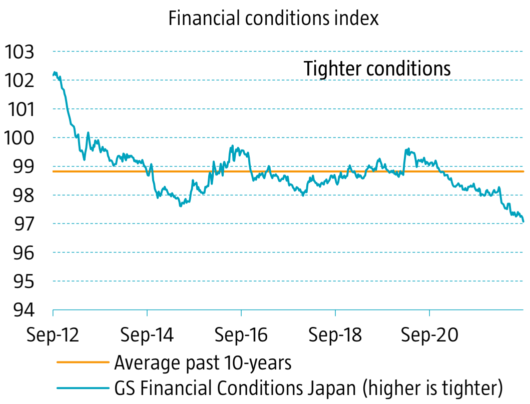
We therefore continue to believe any further upward momentum in yields in the near term would provide an opportunity for medium-term investors to build or accumulate long positions. In particular, we think outright long positions in 20yr and 30yr JGBs are very attractive and favor underweighting the 10y sector with profit levels around 25 bps. Effectively, we expect curves to start flattening. If the BoJ decides to alter the YCC later this year, we expect the curve to flatten more aggressively as 10yr yields would move sharply upward.

JGB Curve	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	-0.08	-0.06	-1.6	-0.5
5yr	0.05	0.16	8.6	9.0
10yr	0.24	0.43	5.0	5.2
30yr	1.28	1.36	8.7	8.8

* for a 1pd position over 12 months

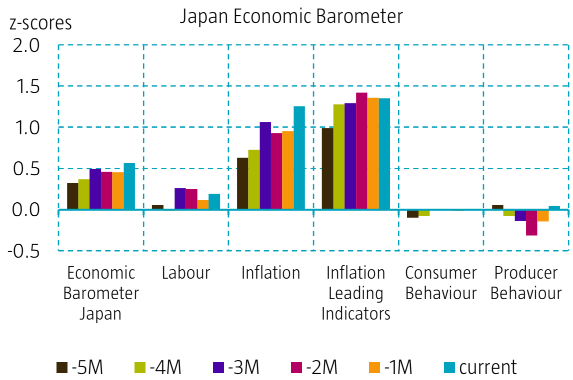
Source: Bloomberg, Robeco; 12 September 2022

Chart 1. Much easier financial conditions



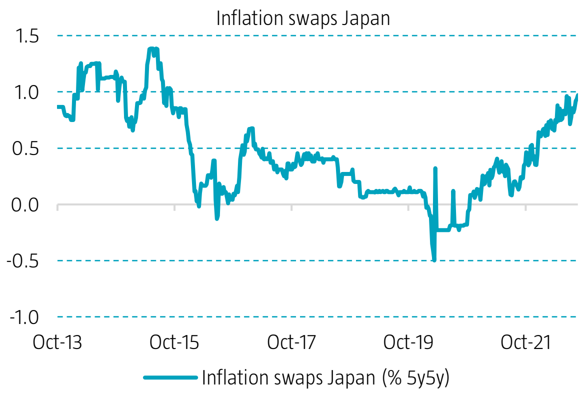
Source: Goldman Sachs, Bloomberg; 12 September 2022

Chart 2. Strong inflation momentum



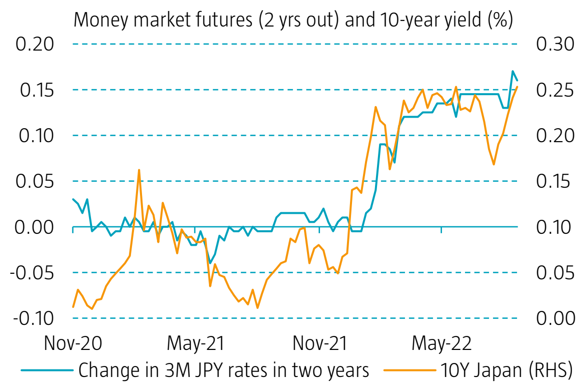
Source: Robeco, Bloomberg; 12 September 2022

Chart 3. Strong improvement in breakevens



Source: Bloomberg; 12 September 2022

Chart 4. Markets price small amount of tightening 2 years out



Source: Bloomberg; 12 September 2022