ROBECO
The Investment Engineers

Central bank watcher

Fearing inflation fears

- Fed: catching up while growth is cooling
- ECB: fragmented inflation fight
- PBoC: quantity over price
- BoJ: under pressure

As recession fears grow and several metal and agri commodity prices have come down, bond markets have priced out a significant amount of central bank rate tightening in recent weeks. The implicit assumption here is that an economic downturn will help central banks get the inflation genie back in the bottle. With inflation yet to show a decisive turn lower, however, concerns that medium to longer-term inflationary expectations could become 'unanchored' from central bank inflation targets are unlikely to dissipate quickly. This could constrain central banks in coming to the rescue if recession were to hit soon. The exception is China, where the central bank retains an easing bias – and inflation pressures and expectations remain contained. For the US, we expect the Fed to hike aggressively in July and September, in order to bring the fed funds rate back to a level seen as neutral. It remains to be seen whether the Fed will be able to take rates much beyond 3%.

Article
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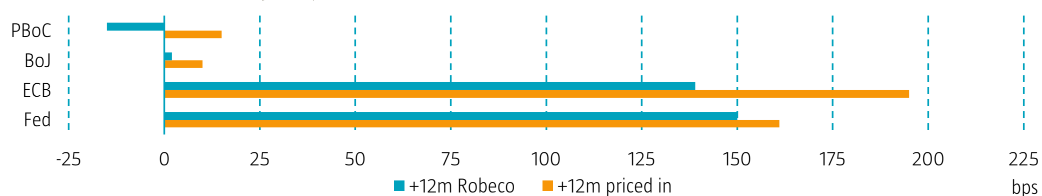
Meanwhile, as the ECB is about to deliver its first hike in 11 years, the focus has shifted to a new anti-fragmentation tool, which should enable the central bank to proceed with rate hikes. We continue to second-guess the market discount that the ECB will sustainably raise the depo rate from -0.5% to above 1.75% in coming years. For now the BoJ is seen as the largest DM outlier as it keeps monetary stimulus going by defending the yield curve control via bond purchases. But that is not without cost, given the strong depreciation of the yen and rising illiquidity risks in the JGB market. Both risks highlight that the BoJ cannot maintain yield curve control indefinitely and we expect changes to come in the next few months.

Outlook for central bank policy rates



Source: Bloomberg, Robeco, change 12m ahead, based on money market futures and forwards; 4 July 2022

The Federal Reserve: catching up while growth is cooling

- Act forcefully now, or risk a much more impactful tightening later
- Only way to avoid large hiking steps is via lower inflation
- Closer to buying moment

Better take the pain now

So the Fed hiked by 75 bps in June and has flagged another step of 75 bps or 50 bps for its 27 July meeting. By the looks of it, the Fed is starting to take inflation seriously. It can be credited for hiking rates aggressively in June, while keeping broader market sentiment reasonably calm with comments that were less hawkish than feared. Still, one could also argue this was a missed opportunity to get the most out of that bold hike. If it is the Fed's goal to contain inflation pressures and to reduce the risk of inflation expectations becoming unanchored, it is probably better off by both acting and sounding hawkish, rather than salving its actions with comforting words. By hiking rates, the Fed is deliberately harming financial conditions in order to cool the economy, which ultimately results in lower price pressures. The more hawkish the Fed acts and sounds, the more impact its actions will have and the faster this process can be ended.

For the Fed, there are two alternatives to being as hawkish as possible now. First, inflation comes down of its own accord and no tightening is needed. Second, act more slowly and take the risk of inflationary pressures not being tempered. There will probably be a monetary balance beam somewhere, where exactly the right amount of tightening results in a smooth cooling process with little damage done to the broader economy. But that beam will be narrow. It's likely that the Fed will fall from it, and for now it would be better off falling towards the side of too much tightening. Rates can rapidly be cut again if needed, but taming out-of-control inflation expectations could easily lead to a longer, potentially much more impactful, tightening cycle.

From their comments since the June meeting, one could conclude there is growing awareness among Fed officials of the pros (and cons) of acting as well as sounding hawkish now. Therefore our base case is for another 75 bps hike on 27 July, followed by a 50 bps step in September. This would take the fed funds rate to 2.75-3.0%. We have another 25 bps penciled in for November, but doubt whether financial conditions and economic sentiment will allow for hikes much beyond the 3% level. As a matter of fact, even hiking past September could be a challenge. If that were to be the case, it would mean that the hikes have done their work. But should financial conditions not have tightened significantly at that point and inflation has not cooled, be prepared for more hikes until at least one of these conditions has changed.

What is priced in for the Fed, versus our expectation

Effective Fed funds rate	1.58	Sep-22	Dec-22	Mar-23	Jun-23
Change implied by FF Futures (bps)		124	177	182	170
Our probably-weighted expectation (bps)		130	155	170	150
Our central scenario (bps)		125	150	150	125

Source: Bloomberg, Robeco; 4 July 2022

Final hike in November is our base case

The market now expects the Fed to hike rates from the current level of 1.5-1.75% to 3.25-3.5% by year end. The Fed is determined to bring rates to at least neutral, which is seen to be at 2-2.5%, so a substantial July rate hike will be hard to escape. Is there a way out of all this expected tightening? Well, after rates are brought to that neutral level, the Fed will gladly pause on any sign of a convincing slowdown in inflation. 'Convincing' means for several months in a row and supported by goods news on underlying inflationary pressures. In this regard, it will be welcomed that the core PCE data for May (0.3% m-o-m) were lower than expected and consumer inflation expectations were revised down, but this needs to be confirmed by core or headline CPI prints of below 0.5% m-o-m. Stabilizing rental inflation and a turn in (Atlanta Fed) wage growth data will also help. This probably makes September the earliest possible moment for a pause or an end to the hiking cycle, while November is our base case. At this point, we also cannot rule out a longer hiking period, though the most recent data suggest the odds are decreasing. We would be alarmed if the Fed were to hike by 'only' 50 bps in July and strike a less hawkish tone, without the confirmation of these lower inflation data. That could bring short-term relief, but potentially much larger troubles ahead.

From September on, the Fed's balance sheet reduction, or QT, will shift to its maximum pace of USD 60bn in Treasuries and USD 35bn in MBS per month. Relative to GDP, we should expect the amount of QT done in the 2017-2019 episode

times three. This will help to tighten conditions, but probably not by a lot. The NY Fed staff recently estimated that its overall impact should be comparable to 50-75 bps in rate hikes in total and a 50 bps rise in the 10-year term premium.

USTs	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	2.83	2.92	152	8
5yr	2.88	2.94	61	1
10yr	2.88	3.01	34	2
30yr	3.10	3.10	13	-1

* for a 1pd position over 12 months

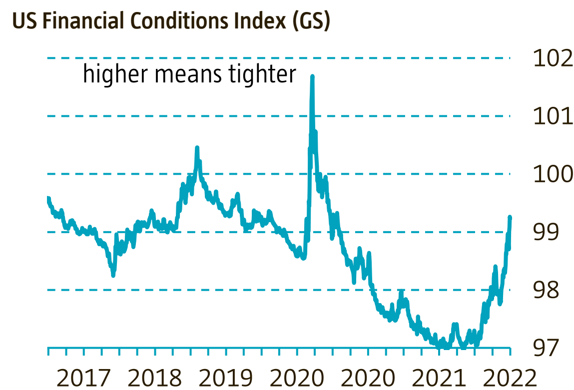
Source: Bloomberg, Robeco; 4 July 2022

Buy signals seem to be getting closer

After the jump in interest rates in recent months, our attention has been shifting towards trying to find markers that could help us identify entry points for long positions in US Treasuries. Our analysis of data since the 1960s suggests that the peak in headline inflation is an ill guide for identifying turns in nominal yields. Core inflation is just as bad a signpost, with lead-lags versus a rates peak of many months. More reliable indicators for the timing of entering long positions have been a 2s10s curve inversion, with a delay of some months, and the second-to-last rate hike. In our base case we would locate the second-to-last rate hike in September, but it could well come later, depending on the inflation data. The 27 July meeting is probably the earliest moment for this second-to-last hike. The 2s10s curve briefly inverted in April and is now very close to a second inversion. This also points to more favorable conditions for entering long positions in the coming months. On the curve, we are in a transition phase from flatteners to steepeners. We see potentially interesting steepening opportunities in 5s10s and 10s30s. For now we advocate a butterfly that is long the 5-year versus 2-year and 10-year wings.

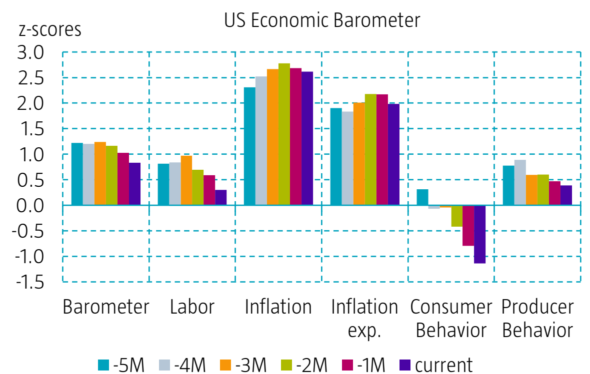
Consumer confidence and housing data have been the driving force behind the decline in the US Economic Barometer in recent months. Inflation expectations as expressed in 5y5y inflation swaps have been stabilizing recently at a level of 2.5%. Financial conditions have continued to tighten, but are still only at levels seen during most of 2018.

Chart 1. Tightening of US financial conditions has continued



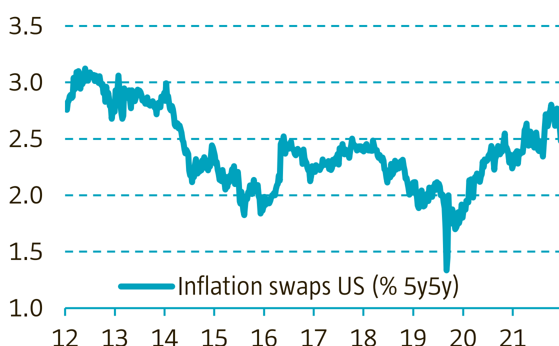
Source: Robeco, Goldman Sachs, Bloomberg; 4 July 2022

Chart 2. Barometer slows on consumer data



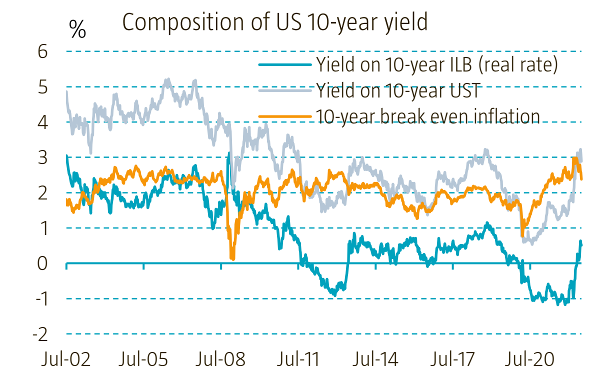
Source: Robeco, Bloomberg; 4 July 2022

Chart 3. Inflation forwards have moderated



Source: Bloomberg, Robeco; 4 July 2022

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



Source: Bloomberg, Robeco; 4 July 2022

European Central Bank: fragmented inflation fight

- Anti-fragmentation tool to facilitate rate hike normalization process, but rising recession risk thwarts it…
- …*sustained* rise in policy rate to 1.75%, as longer-dated forwards imply, hard to envisage
- Still biased to tighter swap spreads, with risk-off and further IRS paying a risk

How far will the ECB get?
Broadening and intensifying inflation pressures prompted the ECB to announce the imminent end of net bond purchases under its remaining QE-program APP at the June meeting. It also de facto pre-announced a 25 bps interest rate hike later this month, to be followed – probably – by a bigger 50 bps move in September. It seems the bar for kicking off the hiking cycle with a 50 bps move (as the SNB did last month) is very high. From the statement and press conference it became clear that the ECB has become increasingly concerned that high current inflation will feed through into expectations and wages, and hence could persist.

The further spread widening in European bond markets on the days following the June meeting also sparked fresh anxiety. Within a week, an ad hoc meeting culminated in a decision to start applying flexibility in reinvesting redemptions coming due in the PEPP portfolio. We see this as a temporary fix, as the composition of holdings across jurisdictions eventually needs alignment with the capital key of the national central banks. This means the funding of extra reinvestments in a member state with redemptions from others ultimately needs to be reversed. The ECB seems to agree, as the second decision taken at the ad hoc meeting was to speed up the design of a new anti-fragmentation tool to preserve the equal transmission of monetary policy across the Eurozone. We expect such a tool to be agreed upon in principle in July. Like with the launch of the OMT in 2012, the full details may not be known and agreed upon until the subsequent meeting, i.e. in September. We do not exclude the possibility that this may be accompanied by a shortening of the reinvestment horizon for QE holdings (currently "until at least the end of 2024" for PEPP redemptions and "for an extended period of time past the date when it starts raising policy rates" for those under the APP).

As for the features of the new backstop tool, we expect no ex ante quantitative limits to be set, and that, unlike the OMT, there will be no 3-year maturity cap. We also expect lighter conditionality (tied to fiscal consolidation and reforms rather than an EFSF/ESM program) and sterilization via money market operations (such as issuance of ECB certificates) rather than through active selling of QE bonds. If indeed successful in containing the widening potential of country spreads over Germany, it would facilitate the ECB in embarking on a "sustained" path of further rate hikes, as the June policy statement signals. However, how fast and far the ECB will ultimately raise policy rates will be data dependent. While Eurozone core inflation edged lower in July, from 3.8% to 3.7%, mainly thanks to temporary fiscal easing measures in Germany, the inflation picture is unlikely to start showing a convincing improvement until Q4, unless wholesale energy prices were to plunge.

Hence, despite increased signs of an impending economic slowdown, financial markets still price in more than 125 bps of rate hikes for the four meetings remaining this year (see table below) and an additional 75 bps in 2023 and 2024. We struggle to believe the ECB will be able to sustainably raise policy rates to 1.75% as longer-dated forwards imply (Chart 1). Indeed, we doubt that all Eurozone economies can structurally handle such tighter nominal financing conditions (Chart 2 and 3), and believe fragmentation within the Governing Council will grow as the economic outlook darkens. In short, an aborted hiking cycle or reversal further out still is our base case. That said, we acknowledge that the inflationary backdrop is such that it will be hard for markets to (fully) price this near term.

What is priced in for the ECB versus our expectations

ECB deposit facility rate	*-0.50*	Sep-22	Dec-22	Mar-23	Jun-23
Change implied by OIS (bps)		76	139	172	195
Our probability-weighted expectation (bps)		75	123	135	139
Our central scenario (bps)		75	125	150	150

Source: Bloomberg, Robeco; 4 July 2022

DBR curve	Spot yield	12m Fwd	Carry* (bp)
2y	0.57	0.88	80
5y	0.98	1.14	47
10y	1.27	1.45	30
30y	1.60	1.63	10

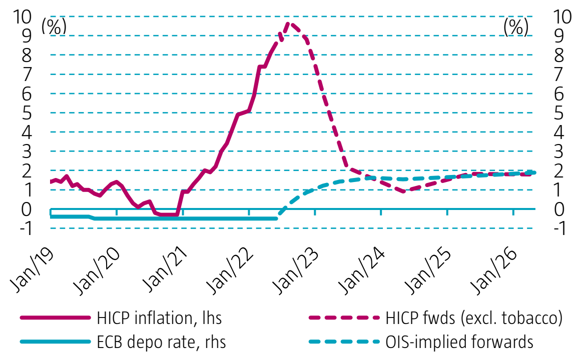
* for a 1pd position in cash bonds over 12 months

Source: Bloomberg, Robeco; 4 July 2022

Still biased to tighter swap spreads with risk-off and further IRS paying a risk

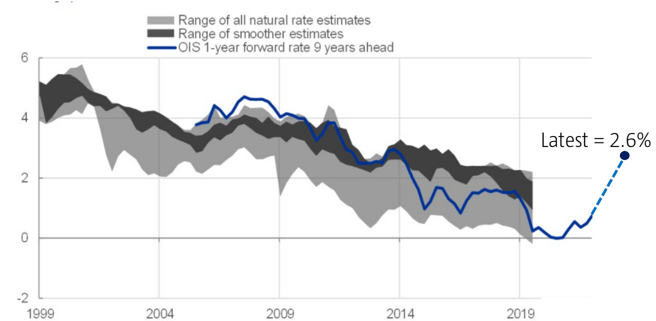
- German 10-year government bond yields continued their uptrend in June, despite having come off sharply from the peak set around the middle of the month. The further yield rise last month was driven by higher rate expectations as well as further term-premium decompression in the context of ongoing elevated rates volatility. In the wake of a further darkening of the European growth outlook, rate expectations have come down in recent weeks and markets are now pricing in a policy rate peak in the coming cycle of around 1.50-1.75% (rather than above 2%).
- As said, we struggle to believe the ECB will be able to *sustainably* raise policy rates by 200-225 bps. Moreover, at above 2.50%, the EUR 1-year OIS rate 9-year forward – assuming term premium and OIS-policy rate adjustments cancel each other out – still exceeds the range of estimates of the long-term 'neutral' ECB depo rate (Chart 2). This makes us reluctant to recommend underweight positions in the 5 to 10-year area, certainly in swaps. Note that *real* 10-year OIS rates are also hovering in the upper half of their 10-year historical range (Chart 4).
- While having become more constructive on EUR duration, we refrain from advising a *large* outright overweight position just yet and prefer to express longs via cross-market positions (e.g., versus the US). This is because we think that given the elevated near-term inflation profile, markets will be slow to price in lower policy rates in the 5 to 10-year part of the curve despite increased recession risks. We keep a flattening bias on the 2s10s curve and would hedge further bull-steepening risk, by setting 10s30s steepeners.
- As for German swap spreads, we retain a strategic tightening bias, assuming some German repo normalization and a drying-up of swap-paying flows, but we acknowledge that increased recession risks might imply swap-spread tightening takes longer to materialize.

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



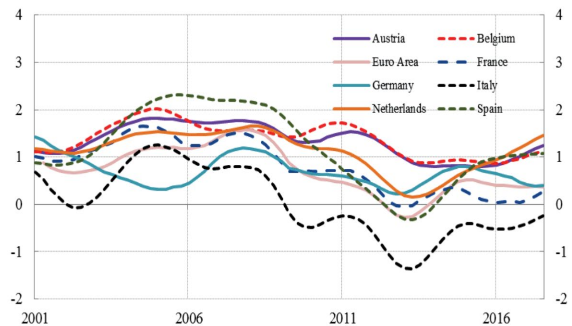
Source: Bloomberg, Robeco; 4 July 2022

Chart 2. Market embraces new neutral rate regime



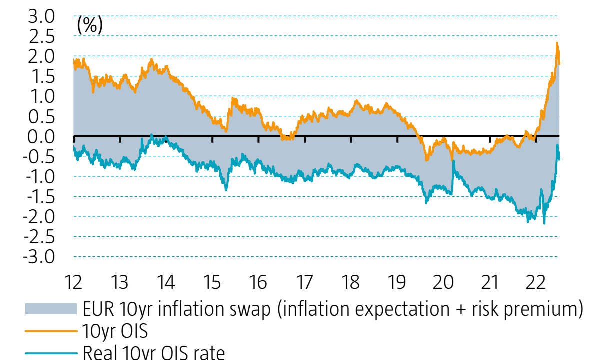
Source: Bloomberg, ECB, Robeco; 4 July 2022

Chart 3. Estimates of Italy's neutral rate* below that of EZ average



Source: Brand et al. (2018), The Natural rate of interest: estimates, drivers, and challenges to monetary policy, ECB, Robeco; 4 July 2022
* shown in real terms here

Chart 4. Nominal and real 10yr OIS rates



Source: Bloomberg, Robeco; 4 July 2022

People's Bank of China: quantity over price

- Authorities opt for injecting more debt to prop up growth amid less-restrictive Covid situation
- Zero-Covid policy, fragile consumer demand, and contained inflation still point to skew in policy rates outlook
- Awaiting a further cheapening in 5-year rates before adding to (cross market) longs

Maintaining a skew in our rates outlook

The overall Covid situation in China seems to have brightened from one or two months ago. Restrictions have become less widespread. In the wake of this, mobility and high-frequency macro data have bounced, albeit not yet translating into a turn in our Economic Barometer (see next page). Meanwhile, our understanding is that the Covid policy has been loosened somewhat, as evident from the reduction of quarantine periods for international travelers and those who have been in close contact with infected people. Nonetheless, it is prudent to assume that future outbreaks and restrictions will occur until the zero-Covid policy really ends.

To prevent economic growth from strongly undershooting the 2022 target, policymakers have gone all in on boosting infrastructure investment, as in 2015 when property was also a heavy drag on growth. Besides the issuance of more special local government bonds, the infrastructure loan quota for policy banks has been ramped higher. Moreover, on the property side, we have witnessed ongoing relaxation of earlier tightening measures by local governments, and even the (re)introduction of 'housing coupons', which are a form of stealth fiscal stimulus. While the easing and re-opening following lockdowns have helped engineer a big cities-led recovery in property sales, it seems premature to conclude that housing demand has turned the corner (the latest PBoC survey of urban depositors supports this cautious stance). That said, the (upcoming) bounce in overall economic activity, and the pick-up in headline inflation do make it less likely that significant policy rate cuts would be embraced, despite the still-subdued core inflation pressures.

Since the 10 bps cut in the one-year MLF rate and 7-day reverse repo rate in January, the PBoC has resorted to a smaller than usual effective 30 bps cut in the reserve requirement ratio (RRR) for banks, increased relending programs for banks to encourage loans to (small and medium-sized) companies, and stealth easing by guiding money market rates to below the policy rate corridor (Chart 1). Noticeably, the removal from the Q2 monetary policy statement of the pledge "to keep macro leverage ratio broadly stable" suggests the PBoC is keen to steer the closely watched "credit impulse" (further) into positive territory (Chart 3). It seemingly prefers to achieve this by actively steering the quantity of credit rather than by aggressively reducing its price. Still, contrary to financial markets, we keep an easing bias in our outlook for China policy rates (see table below). In a world where many economies could be slipping into recession over the next 6-9 months, the change of a rate cut still seems higher than that of a rate hike.

What is priced in for the PBoC versus our expectations					
PBoC 7-day reverse repo	*2.10*	Sep-22	Dec-22	Mar-23	Jun-23
Change implied by forwards (bps)		0	4	14	15
Our probability-weighted expectation (bps)		-3	-6	-9	-15
Our central scenario (bps)		0	-5	-5	-10

Source: Bloomberg, Robeco; 4 July 2022

While 10-year CGB yields have hovered in a narrow 2.75-2.85% range since February, 5-year CGB yields and especially 5-year offshore NDIRS rates have been trending higher. We would await a further reduction in the gap between 5-year and 10-year rates before contemplating adding to (cross-market) long positions, in 5-year CGBs. Note that since the deposit reform in April, deposit rates are referenced to the 1-year LPR and 10-year CGB yield – which, in our view, makes it more problematic (certainly for banks) if the 10-year CGB yield were to rise sharply. More structurally, we continue to believe that the elevated overall indebtedness and China's demographic outlook will require lower equilibrium policy rates, which should translate into lower CGB yields over the coming years.

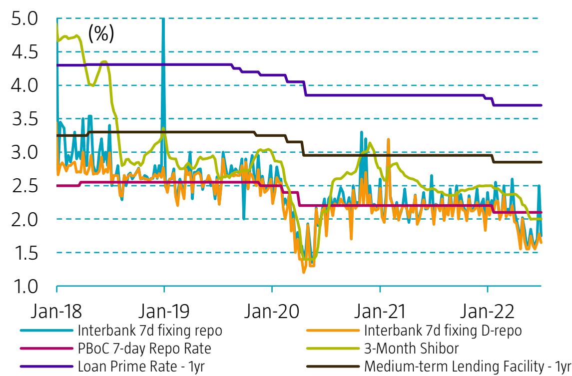
CGB curve	Spot	12m Fw
2yr	2.29	2.70
5yr	2.67	2.93
10yr	2.84	3.02

Source: Bloomberg, Robeco; 4 July 2022

Economic barometer has stopped falling

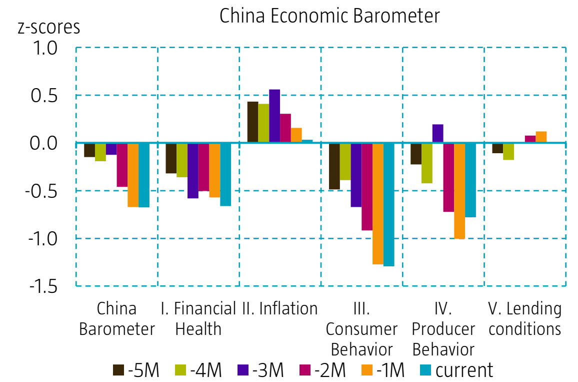
- Our economic barometer for China slipped further into negative territory in recent months. But it has stopped falling and looks set to pick up somewhat as broader macro data starts to reflect the June pick-up in mobility.
- The consumer component still has the lowest Z score due to, among others, the significant drag from still-weak retail sales and a still very weak marginal-propensity-to-consume metric (based on household demand deposits relative to savings deposits).
- Meanwhile, the producer-behavior component has started to improve, reflecting the bounce in industrial production, rail freight traffic and the PMI new orders index.
- One relative bright spot is 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 finally moved out of negative territory (see Chart 3).
- The overall Z score for 'inflation' remains in marginal positive territory, thanks to the slowing but still-elevated level of PPI inflation. The components measuring underlying inflation pressure remain subdued, providing the central bank room for maneuver as it keeps on going against the global tightening flow.

Chart 1. Selected policy and money market rates



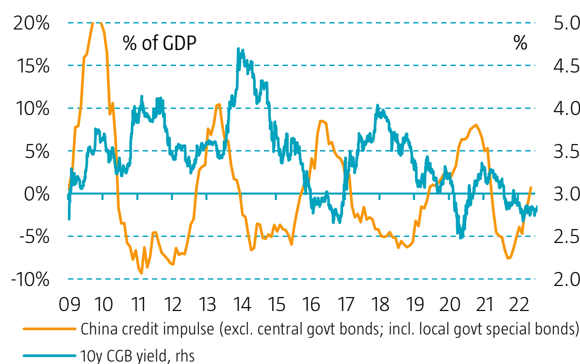
Source: Bloomberg, Robeco; 4 July 2022

Chart 2: Barometer still in the doldrums



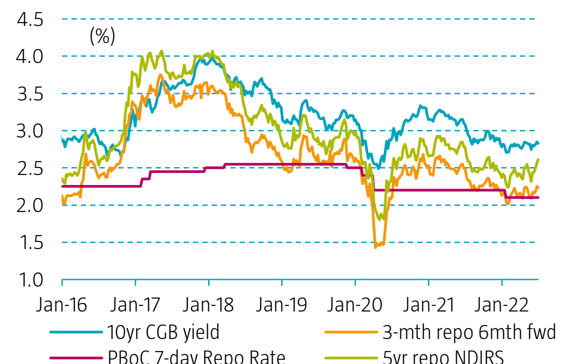
Source: Bloomberg, Robeco; 4 July 2022

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



Source: Bloomberg, Robeco; 4 July 2022

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



Source: Bloomberg, Robeco; 4 July 2022

Bank of Japan: under pressure

- BoJ holding the line for now
- The loss of yen
- Change is coming

BoJ holding the line for now

The BoJ held the line (yet) again at its latest monetary policy meeting, pushing back on expectations that a change in its monetary policy setting is on the horizon. Indeed, in the run-up to the meeting, markets had speculated that the BoJ would alter its yield curve control (YCC) mechanism by either moving the target from the 10-year point to the 5-year point or simply widening the band by 25 bps. This put a great deal of upward pressure on the 10-year JGB yield, which the BoJ was forced to defend. The BoJ wrapped up its June monetary policy meeting with an 8-1 majority decision to keep its current monetary policy mix and easing bias in place. The decision to keep the easing bias leaves the BoJ increasingly isolated at a time when other central banks are growing more hawkish and acting upon their messaging to markets, as evidenced by the Fed's +75 bps rate hike and the surprise steps by the Swiss National Bank (SNB) and Reserve Bank of Australia (RBA). For now, this also means further monetary policy divergence between the BoJ and the rest of the world. The BoJ left its assessment of the economy and prices largely intact, stating that the economy was somewhat improved as the country still has some reopening momentum, while headline CPI has been ticking higher as expected. Still, the BoJ emphasized that the traditional core measure of inflation, which excludes fresh food, is likely to touch the 2% level due to rising energy and food prices, but is likely to decelerate quickly once the base effects kick in in Q4, keeping the BoJ firmly in the transitory inflation camp. Inflation excluding food and energy, the better measure of underlying price pressures, indeed shows that Japan is hardly seeing any form underlying price pressure. It is expected to touch 0.8% in Q3, but that is hardly a problematic level, especially when compared to core inflation rates elsewhere in the world. Here, too, there is a widening gap with other central banks, which have become increasingly concerned about the upside inflation risk.

The loss of yen

The BoJ holding the line on monetary policy versus its global peers has huge ramifications for the yen. The yen remains on a strong depreciation trend driven by this monetary policy divergence, and is now also a key focus for markets. The more the yen weakens, the stronger the speculation will be about possible currency interventions by the Ministry of Finance (MoF) and a potential BoJ U-turn on monetary policy. Perhaps against expectation, the BoJ remained silent on the yen. It likely did so out of consideration for the potential market impact of such an assessment (the risk of fueling market expectations for a policy change). Instead, the BoJ limited itself to a statement in its risk assessment that "it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices." However, it is arguably becoming more difficult for the BoJ to stick to its effectively constructive view of JPY weakness without an explicit assessment, given that concerns about accelerating currency depreciation have intensified and become a point of contention between ruling and opposition parties heading into the upper house election on 10 July. Indeed, there are worries that ongoing depreciation would eventually lead to more headline inflation. Equally, high levels of inflation like this tend to work as a tax on consumption, and there is therefore the risk that inflation could become a political issue, as has been the case in many other countries.

What is priced in for the BoJ, versus our expectation

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

Source: Bloomberg, Robeco; 4 July 2022

We would partially side with the BoJ that a weaker yen also has benefits, such as making exports more globally competitive. That said, we would argue that a cost-benefit analysis is required on policy mix. Given that the BoJ now is forced to defend the YCC target by buying extremely large amounts in the JGB market, including targeted purchases in the cheapest-to-deliver bond to push out speculators, has led to a complete drying-up of liquidity in the JGB market, thereby raising financial stability risks.

Change is coming

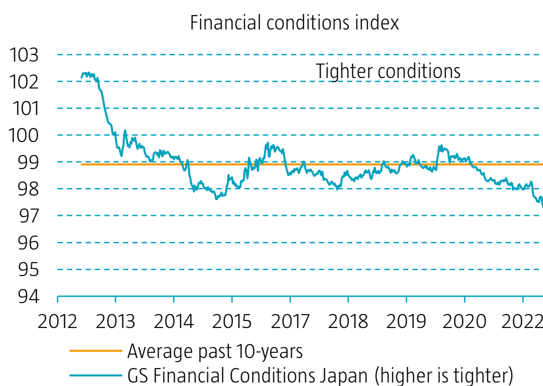
As flagged in previous Central Bank Watchers, we believe the time is coming when the BoJ will finally start exiting (some of) its easing bias. It is becoming increasingly difficult for the policymaker to maintain this stance while negative externalities are piling up. In that sense, the cost-benefit analysis is turning negative. Indeed, we worry about financial stability risks in the Japanese financial system as JGB liquidity has dried up while the yen seems to be depreciating relentlessly. We think the BoJ is becoming more aware of the issues and realizing it is playing a match it can not win. The July meeting is interesting in that sense, as the BoJ will present its quarterly outlook report including updated GDP and inflation forecasts. If they want to maintain their credibility, they would need to be more explicit on the yen and its impact. Hence we stick to our view as outlined in previous Central Bank Watchers, namely that the summer cycle of monetary policy meetings will be best suited for an announcement of monetary policy changes. The first step would be changing the YCC framework by either widening the 10-year bandwith by an additional 25 bps or moving the YCC target from the 10-year to the 5-year point. We are humble on the actual timing but the July and September meetings are 'live' meetings in that sense. Given the asymmetric pay-off of 10-year JGB yields in case of any change they make (they can only go up), we like to stay underweight 10-year JGB futures.

JGB Curve	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	-0.07	-0.04	-1.4	-0.9
5yr	0.01	0.12	4.5	4.6
10yr	0.22	0.39	4.5	4.6
30yr	1.26	1.27	7.9	7.9

* for a 1pd position over 12 months

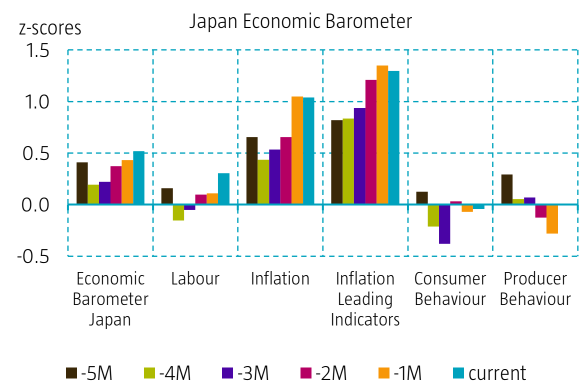
Source: Bloomberg, Robeco; 4 July 2022

Chart 1. Easier financial conditions



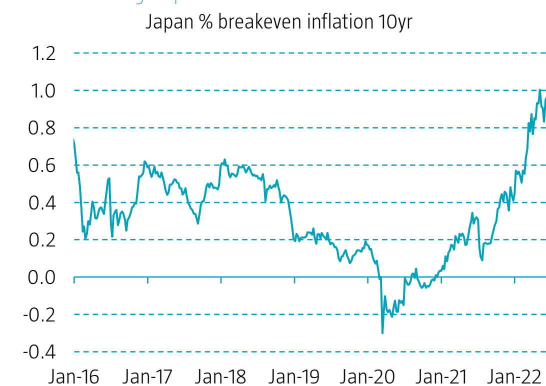
Source: Goldman Sachs, Bloomberg; 4 July 2022

Chart 2. Economic improvement stalls



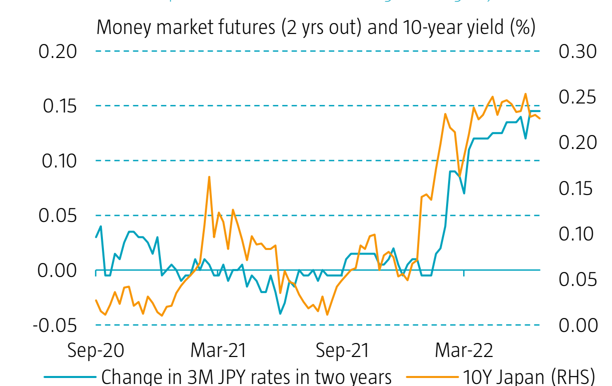
Source: Robeco, Bloomberg; 4 July 2022

Chart 3. Strong improvement in breakevens



Source: Bloomberg; 4 July 2022

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



Source: Bloomberg; 4 July 2022

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