Treasury Monthly Market Commentary 08|22

ECB joins the rate hike club; The ECB finally joined the ranks of its peers and raised rates for the first time in 11 years from -50bp to zero. The move which was on the larger side of market predictions came days after the euro fell below parity against a USD trading at 2 decade highs. The ECB had previously heavily hinted it would move 25bp, the euro's plight on the FX markets, which fans inflation already approaching 9%, seems to have changed their sentiment. Lagarde, the ECB President, stated she would no longer provide forward guidance of any kind. She also announced a tool (TPI) which could be used to prop up individual sovereign's bonds if markets became unruly.

Fed goes 75 again; The Federal Reserve again increased their target rates by 75bp in July to take them to 2.25-2.50%. As we approach what is perceived to be the neutral rate concerns regarding the ability of the economy to withstand this pace of rate adjustment grow in importance when pitted against the need to contain 40 year high inflation. Comments after the meeting by Fed Chair Powell were perceived to be more dovish in nature as he too backed away from forward guidance and said future rate adjustments would be on a meeting by meeting basis. So the market and the Fed are now data-watching and perceptions of where rates will go may change markedly if data releases are not as forecast. Essentially we will likely see more volatility going forward.

Acknowledging that the economy is showing signs of slowing and the Fed may have to adopt a slower pace of rate increases was taken as more dovish than expected by the market and yields across the curve dropped. The 10y UST which in June was closing in on 3.50% began August a few basis points from 2.50%, after a weaker than expected GDP release. Fed members that had signaled they did not want to provide forward guidance were suddenly queuing up to assure the market they were "laser focused" on addressing inflation "nowhere near" done on fighting it. The 10y yield obliged and bounced back to 2.80%, as we say, more volatility.

BoE acknowledges 25bp is not fast enough; The BoE's 50bp move, the largest single move for 27 years, was greeted with the market selling GBP 1% lower. With a mandate to keep inflation 1% either side of 2% the current rate of 9.4% which they predict to now hit >13% in October they felt it necessary to raise at a faster pace in the face of a slowing economy to try and prevent inflation becoming baked in. In line with their peers forward guidance was scrapped "all options are on the table for our September meeting, and beyond that". They now expect the economy to shrink by 2.1% in total, falling into recession in Q4 and lasting for all of 2023 as real disposable income falls more than any time in around 60 years. UK yield curves started to invert on the back of the BoE's gloomy predictions. The Bank laid out plans to start the outright selling of their balance sheet holdings starting September at £10bln per quarter which along with not reinvesting redemptions will lower its gilt holdings by £80bln in the first year. The Bank was the first major central bank to initiate rate hikes back in December and is now leading the charge in active selling of their QE stockpiles.

More geopolitics; Tension between Washington and Beijing cranked up as US House Speaker Nancy Pelosi made a brief but significant visit to Taipei which Beijing warned was "playing with fire". China announced 72 hours of live-fire exercises around Taiwan as it stated its military "will not sit idly by". Japan became embroiled in the brinkmanship as 5 missiles fired by China landed inside the country's "exclusive economic zone" which China does not recognise.

Markets wise; The USD is treading water at near 20 year highs as dips below EUR/USD 1.0000 and GBP 1.2000 have proved short-lived. After peaking just shy of 3.50% mid-June 10yUST yield is in a current downtrend after testing 2.50%. 2-10 yield inversion approaching 40bps the most since 2000. Equities continue to stage a comeback as continual aggressive action by the Fed gets priced out. These are volatile times though.