Morning Comment

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AFS Insights

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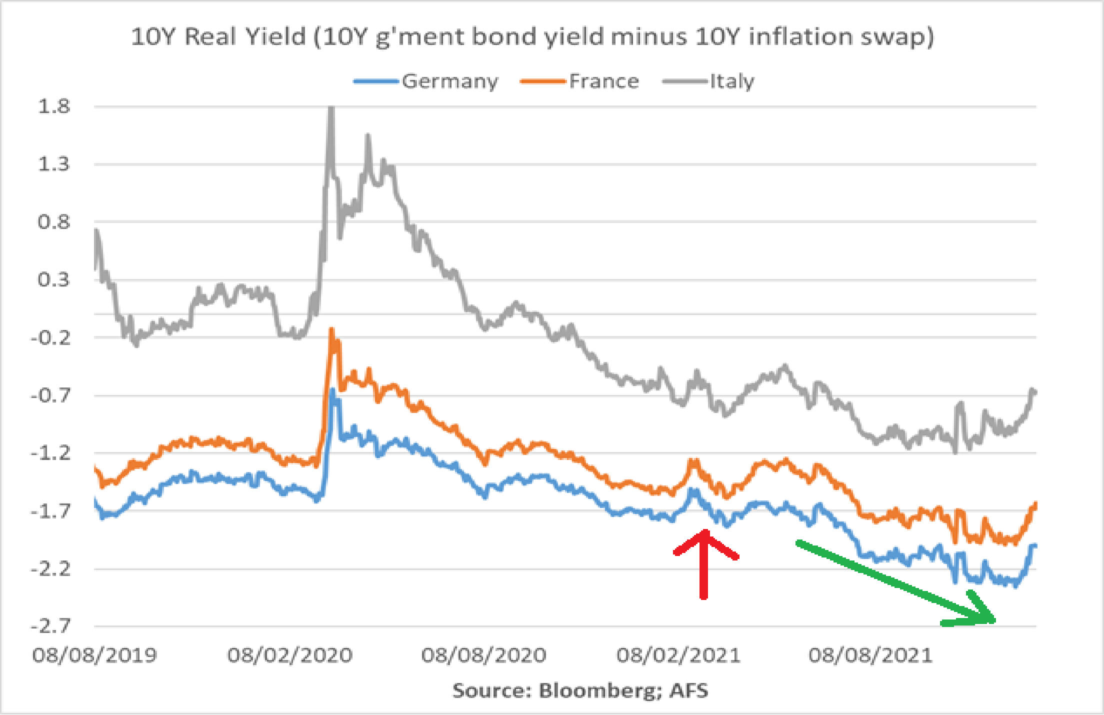
Headline Sweep

- U.S. braces for Russian escalation as Ukraine talks hit "dead end"
- Several Ukraine Ministry Websites Struck by Likely Cyberattack
- U.K. Set to Abandon Covid Passes This Month: Times
- Kaufman, 1970s Wall Street Dr. Doom, Blasts Powell on Inflation
- Fed's Brainard Signals She's Open to Raising Interest Rates in March
- Biden Picks Fed Bank Regulator, Adds First Black Woman to Board
- US Supreme Court blocks Biden's workplace vaccine mandate
- Biden voting plans dealt crushing blow by fellow Democrats
- China Outbreak Reaches Six Provinces as Omicron Takes Hold

Anatomy of a bond market sell-off

- **Some somewhat belated thoughts on the spike in long end bond yields this year.** Given the decline in real yields in the second half of 2021 (green arrow in the chart below), bonds were vulnerable to a correction:



Apologies for the bad paint skills.

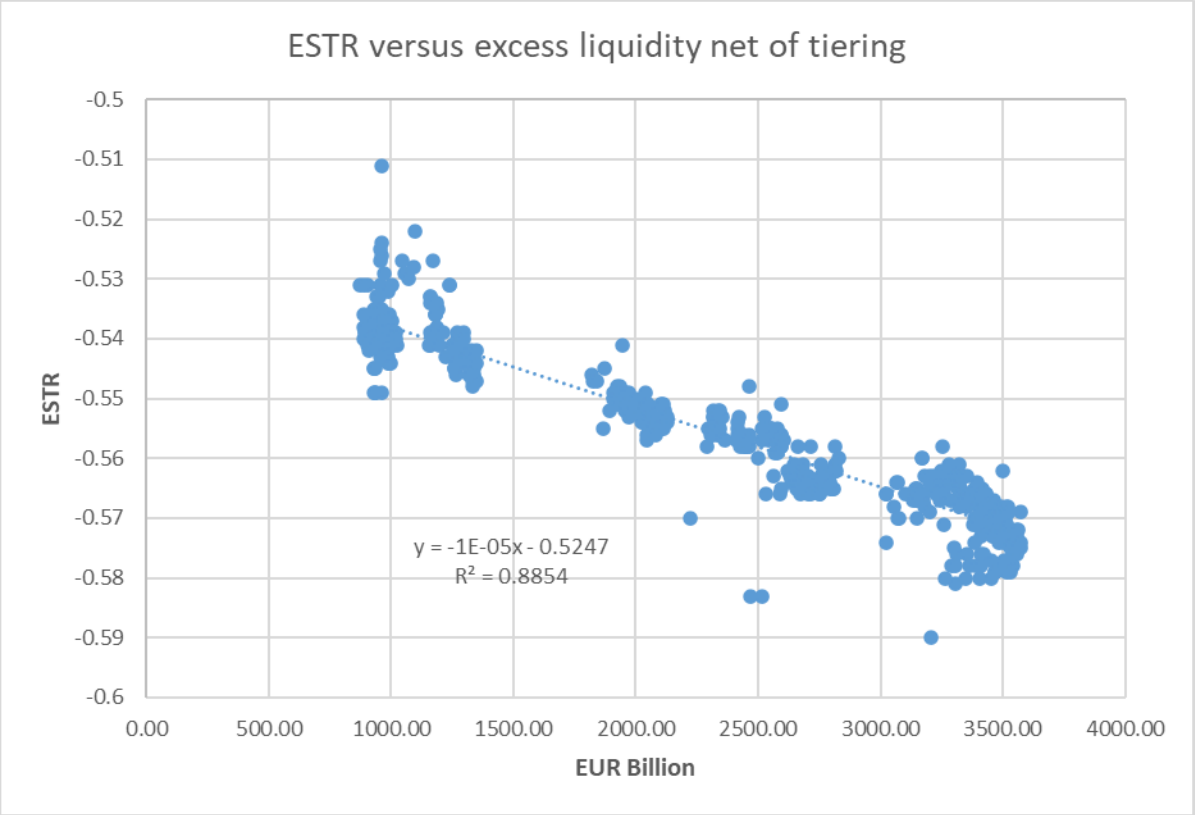
- **Notice the red arrow in the chart above**. That was the real yield spike in the first months of 2021, which did invoke a response from the ECB as inflation was still benignly low, the economy was in a recession and ICU capacity across the continent was stretched to the limit because of a lethal Covid wave. Nowadays, with the economic recovery still assured, uncomfortably high inflation readings and Covid having lost its lethality, even the ECB is looking for the exit of extremely loose policy. Expect our central bank overlords in Frankfurt to give their quiet blessing to the bond market sell-off. That is, unless – say – real yields substantially exceed the 2021 highs, nominal bond yields surpass their 2018 and 2019 levels and when ESTR OIS bring forward ECB tightening to the autumn of this year. The ECB's top brass, we're thinking of Lagarde herself and her chief economist Lane, is still in camp transitory when it comes to inflation. Unless they change their tune on inflation, expect nothing more than a pushback on near term rate hike jitters from them.[1]
- **And speaking of rate hikes, part of the rise in bond yields can be explained by repricing the ECB (again). Here are ESTR OIS forwards:**

ESTR OIS forwards

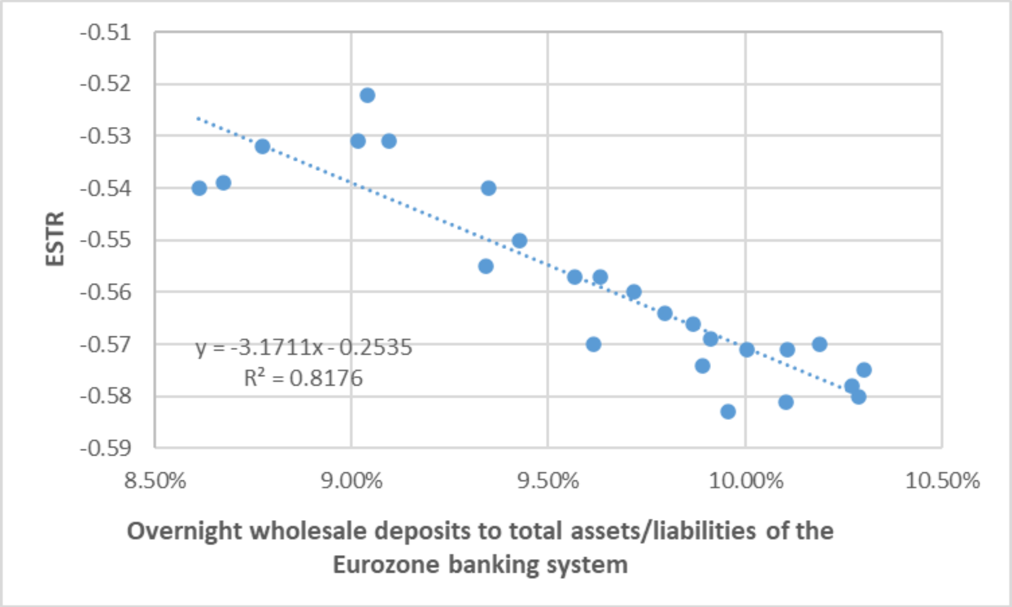
	1M1M	3M1M	5M1M	6M1M	9M1M	10M1M	1Y1M	15M1M	18M1M	21M1M	2Y1M	3Y1M	4Y1M	5Y1M
13/01/2022	-0.574	-0.567	-0.542	-0.532	-0.492	-0.453	-0.287	-0.287	-0.120	-0.120	0.029	0.091	0.103	0.187
12/01/2022	-0.576	-0.569	-0.545	-0.535	-0.483	-0.467	-0.297	-0.297	-0.144	-0.127	0.002	0.094	0.107	0.187
06/01/2022	-0.577	-0.572	-0.565	-0.558	-0.528	-0.507	-0.319	-0.319	-0.183	-0.179	-0.019	0.052	0.104	0.179
02/12/2021	-0.574	-0.574	-0.561	-0.561	-0.534	-0.544	-0.435	-0.435	-0.359	-0.357	-0.230	-0.219	-0.179	-0.077

- **By way of convention we have dubbed the 5-year forward the market estimate of the neutral rate of interest for the Eurozone.** The 30bps increase since early December will not exactly set the world on fire. Where we take offence and see opportunities is near term pricing.
- **Take the six-month forward ESTR rate.** If we dismiss the next to zero odds of a June ECB rate hike, ESTR at minus 54 consistent is historically consistent with excess liquidity at 1,000 billion euros:

[1] Our intuition tells us to keep an eye on the French election and ECB policy. Don't ask us why just yet.



- **How does one arrive at excess liquidity net of tiering of 1,000 billion euros, down from 3,400 to 3,500 billion euros in the present?** For starters, TLTROs would have to revert to their pre pandemic level, a decline of 1,600 billion euros to 600 billion euros. And the ECB would have to increase the tiering facility multiplier to 11 from 6, which would drain roughly 800 billion euros in liquidity. In our eyes, that's logically impossible. If the ECB raises the tiering multiplier, that's with the intention to prevent bad optics of the balance sheet shrinking overnight by a psychologically too large amount of TLTRO repayments (think 1,000 billion euros or so or more).
- **Mispricing in OIS forward rates is even more pronounced in the 9-month forward period.** For such pricing to be justified, one would have to expect a Damascene conversion by the ECB to inflation fighting *and* inflation rates that Lagarde & Co can no longer explain away. Oh, and make a U-Turn in – from the ECB's perspective – in a blink of an eye. And then raise rates in September. Notice that we're not making calls on inflation here, which we aren't able to do anyway. This view is based on our ECB-watching skills: purely on the time need to turn this gargantuan oil tanker around.
- **Finally, one can also reason that it's not just excess liquidity that determines the settlement of ESTR relative to the ECB's policy rate.** ESTR is an overnight wholesale borrowing rate after all. And while the ECB directly controls liquidity levels in the banking system, it has no such control over wholesale deposits. As we explained earlier this week, overnight wholesale deposits have continued their relentless rise in the past six months despite excess liquidity levels stabilizing. When the ECB raises tiering and when banks repay TLTROs, wholesale deposits will not change an inch. And as we explained yesterday, there's a strong correlation between wholesale deposits and the settlement of ESTR too:



We wonder if ESTR has become more sticky. That is, lower levels of excess liquidity might not result in linear increases in the settlement of ESTR because of the elevated level of wholesale deposits.

Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
08:45	France	CPI EU Harmonized MoM	Dec F	0.20%	0.20%
08:45	France	CPI EU Harmonized YoY	Dec F	3.40%	3.40%
09:00	Spain	CPI EU Harmonised MoM	Dec F	1.20%	1.20%
09:00	Spain	CPI EU Harmonised YoY	Dec F	6.70%	6.70%
10:00	Germany	GDP NSA YoY	2021	2.70%	-5.00%
10:00	Germany	Budget Maastricht % of GDP	2021	-5.50%	-4.80%
10:30	Italy	General Government Debt	Nov	--	2710.3b
11:00	Eurozone	Trade Balance SA	Nov	1.5b	2.4b
14:15		ECB President Lagarde Speaks before EU Parliament			
14:30	US	Retail Sales Advance MoM	Dec	-0.10%	0.30%
14:30	US	Retail Sales Ex Auto MoM	Dec	0.20%	0.30%
14:30	US	Retail Sales Ex Auto and Gas	Dec	-0.10%	0.20%
14:30	US	Retail Sales Control Group	Dec	0.10%	-0.10%
14:30	US	Import Price Index MoM	Dec	0.20%	0.70%
14:30	US	Import Price Index YoY	Dec	10.80%	11.70%
15:15	US	Industrial Production MoM	Dec	0.20%	0.50%
15:15	US	Capacity Utilization	Dec	77.00%	76.80%
15:15	US	Manufacturing (SIC) Production	Dec	0.40%	0.70%
16:00	US	Business Inventories	Nov	1.20%	1.20%
16:00	US	University of Michigan Consumer Sentiment	Jan P	70	70.6
17:00		Fed's Williams Speaks at Council on Foreign Relations			
		Bank of Korea 7-Day Repo Rate	Jan/14	1.25%	1.00%

Consensus data: Bloomberg News; All Times Are in Central European Time