Economic Research Unit

Economics Weekly

Bank of Ireland

Bank of England and ECB highlight market curve may overstate likely pace of future rate hikes

Expectations that central banks will be forced into a series of rate hikes have hardened over the past week. The deteriorating prospects for the conflict in the Middle East being resolved, pushing Brent oil prices above $100pb, has been the clear catalyst, bolstered by rate hikes and the hawkish messages emanating from the Bank of England, ECB and Federal Reserve September policy meetings. Hence, 5-year swap rates are now back close to the peak levels seen in 2022/23 following the outbreak of war in Ukraine. These elevated swap rates also reflect the pessimistic view embedded in OIS curves that central banks will need to keep rates in restrictive territory out to the end of the decade.

However, both the Bank of England and ECB have stressed that the market curve not only captures investors' view of the most likely path for policy rates, but also compensation for risk and uncertainty. Last week, ECB Chief Economist Philip Lane unveiled estimates that c30-40bps of the tightening to 3.5% embodied in the OIS curve reflected such 'term premia'. This view is similar to previous estimates from the Bank of England (c50bps) for the Sterling OIS curve. The message here is that investors' view of the most likely path for ECB policy rates may be two further 25bp hikes to 3%, but with market rates being pushed above 3% because the risks to oil prices and CPI inflation are skewed to the upside.

Expectations for central bank rate hikes harden on inflation fears: Together, deteriorating conditions in the Middle East, pushing Brent oil prices above $100pb, and the rate hikes and hawkish messages delivered following the BoE, ECB and Fed September policy meetings, have hardened the view that central banks will be forced to tighten monetary policy substantially in the coming months. Options are currently fully pricing in three further hikes from the BoE, ECB and Fed to 4.5%, 3.25% and 4.5%-4.75% respectively.

Pushing swap rates to their highest level since the Ukraine war: The upshot is that 5-year swap rates are now at their highest level since the 2022/23 period following the outbreak of war in Ukraine, when surging gas prices pushed CPI inflation into double-digit territory (see chart below). Sterling, euro and dollar 5-year swap rates are now at 4.6%, 3.5% and 4.5% respectively. These elevated swap rates not only reflect expectations of near-term rate hikes from the BoE, ECB and Fed, but also appear to reflect the pessimistic view implied by the OIS curve that central banks will be forced to keep their policy rates at restrictive levels out to the end of the decade.

OIS rates and swaps price in substantial uncertainty: However, in their July Monetary Policy Report, the Bank of England noted that the OIS curve captures not only the most likely path for central bank policy rates, but also risk premia. The BoE estimated the entire upward slope of the OIS curve reflected risk premia (circa 50bps of tightening to 4.25%). Stripping out these risk premia revealed that investors saw the most likely path for Bank Rate as remaining on hold over the next 12-months, before eventually being cut slightly to 3.5% in H2 2027. Put simply, investors are demanding a higher rate for fear of events in the Middle East deteriorating further, causing oil prices and CPI inflation to surge.

Indeed, the minutes of yesterday's (September 17th) Bank of England policy meeting reiterated the point, noting that the median expectation in September's Survey of Market Participants was for Bank Rate to remain on hold for a pro-longed period, in contrast to the upward sloping OIS curve. The minutes indicated that '*elevated risk premia were thought to remain a material contributor to the upward slope in the market curve, consistent with increased volatility across energy and interest rate markets since the onset of the conflict*'. The Monetary Policy Committee's clear view is that investors do not truly believe the most likely outcome is that the Bank of England rate will rise to 4.5%.

ECB estimates c30-40bps of expected tightening reflects uncertainty: Speaking at the Dublin Economics Workshop (DEW) conference on September 11th, ECB Chief Economist Philip Lane made a similar point. Lane outlined that while the OIS curve implied the ECB would raise rates to 3.5%, he unveiled estimates indicating that c 30-40bps of this rise was accounted for by uncertainty, or term/risk premia. Again, the message here is that investors' central view of the most likely path for ECB policy rates was for two further 25bp hikes to 3%, but with market rates elevated beyond that because the risks to oil prices and CPI inflation were judged to be skewed to the upside.

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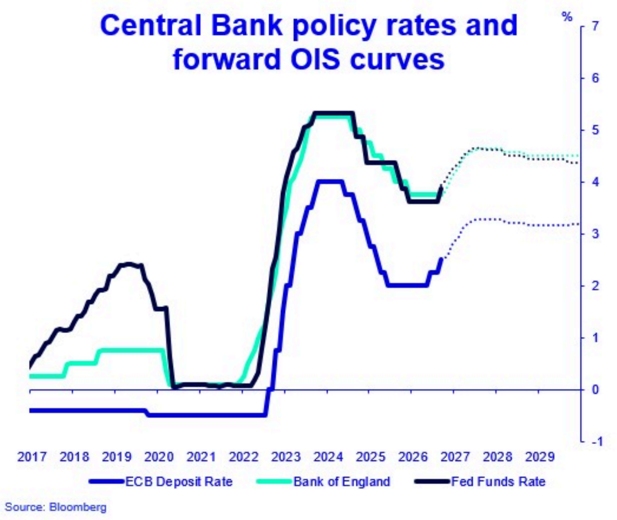

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