Rates: A volatile world warrants EUR steepeners

The euro swap curve is still exceptionally flat by historical standards and forwards don't price any moves from here. With growth holding up, underpriced structural inflation risks and EU spending plan discussions, we see potential for more bear steepening of the 5s10s curve. If recession risks intensify, then we'd see a bull steepening

We don't believe the current yield curve can be an equilibrium outcome – although curves can remain flat if risks keep lurking but never materialise

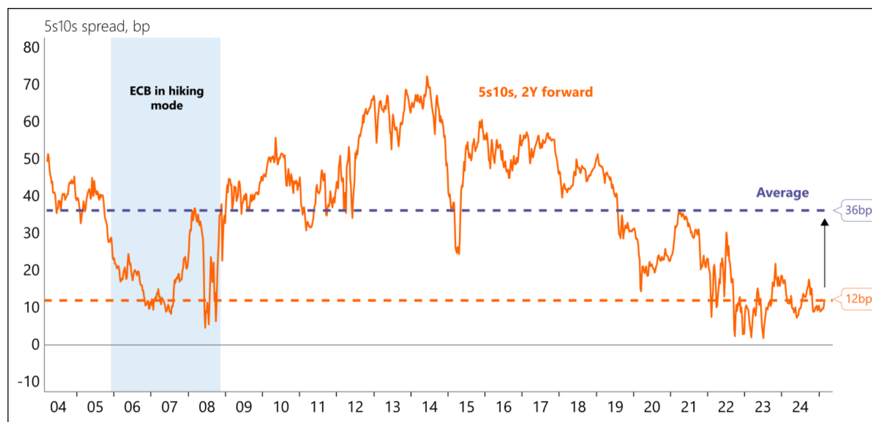
The euro curve in forwards is still exceptionally flat

When we look at the steepness of the euro swap curve in forwards, we see exceptionally flat curves compared to historical norms. The 5s10s in spot rates is strongly influenced by rate cut expectations, which are for a large part expressed by rate expectations in the immediate two years. By charting the 5s10s curve in two-year forwards, we implicitly filter for any near-term monetary policy expectations.

The last time the 5s10s in forwards space was this flat was around 2007, which was when the European Central Bank was hiking rates to address rising inflation. Policy rates were deemed restrictive at this time, flattening the curve. With the ECB currently moving towards a neutral or even supportive monetary policy stance, we would expect more steepening to materialise than so

far has occurred.

Curves are still as flat as during the ECB's previous hiking cycle

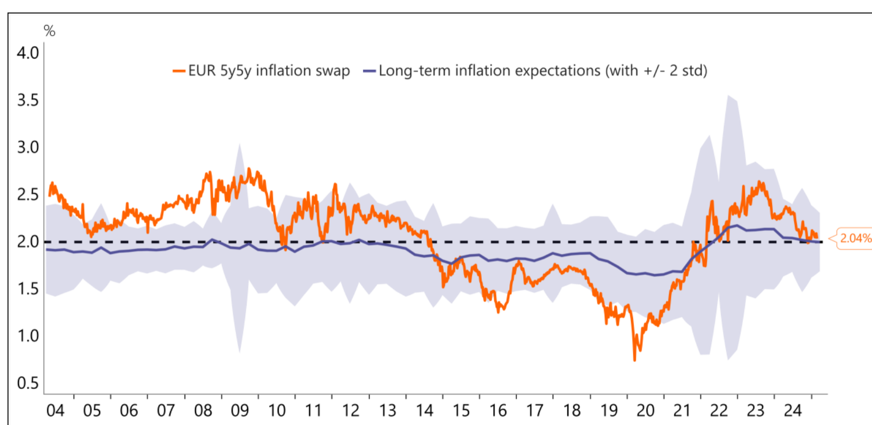


Source: ING, Macrobond

Markets are preventing steepening on structural fears

Curves remain exceptionally flat because markets take a very pessimistic view on the structural outlook of the eurozone. A potential trade war, an actual war, and political uncertainty in France and Germany are all preventing markets from normalising. The 5Y5Y forward inflation swap reflects this pessimism with the risk premium now close to zero, weighing down the 10y swap rate.

Inflation swaps in line with expectations suggests little risk premium



Source: ING, Refinitiv, Macrobond

We see two potential scenarios for where the yield curve will steepen from here: 1) a gradual economic recovery with a rebuild of the term risk premium, or 2) through a sharp rise in recession risk triggering a bull steepening. Our baseline is for a gradual recovery and recent data supports this direction. Talks about defence spending and broader EU reforms can help markets grow more convinced of this as the likely path forward. In contrast, if we do see an escalation of geopolitical risks, then the ECB could be quick to resort to more cuts. Inflation is sticky, but below 3%, and any severe risks to growth can therefore trigger a steepening from the front end.

We don't believe the current yield curve can be an equilibrium outcome, although curves can remain flat if risks keep lurking but never materialise. The uncertainty would prevent the term premium from rebuilding while the front end of the curve would remain where it is. It's hard to imagine a flattening move from here given the already stretched positioning. One would have to see inflation risks pick up while the longer-term growth outlook gets challenged at the same time. As such, the balance of risks favours a steepening of the 5s10s from here.

Reading forwards for future predictions

To understand current market positioning we look at forwards, which are simply a mathematical transformation of spot rates but can nevertheless provide insights about the future. Using US Treasury yield data going back to 1961, we show that since 2000, forwards can help predict changes over short horizons and tenors. The correlation of implied and realised changes of the 1Y rate over short horizons was above 0.3. Over time, the predictability of rates using forwards at shorter tenors improved, which can ironically be explained by the increased focus of central banks on "forward" guidance.

Our results suggest that the value of forwards in predicting the path of tenors beyond three years is limited. The first reason relates to the term risk premium, which becomes increasingly important for longer maturities. This risk premium should be added to the forwards implied path for a purer measure of expected rates.

But perhaps a more important reason as to why longer-dated forwards fail to capture future rate moves is due to systematic forecasting errors. The negative correlation in the heatmap can be explained by the secular decline in rates over the past decades. An upward sloping yield implied rising rates (and positive term premium), but instead the neutral rate was consistently lowered by markets, leading to declines in rates instead.

In our analysis above, we think that markets are too pessimistic on the long-term outlook of expected rates and we foresee a building of the term premium.

Special thanks to Manas Sadasivuni for contributing to the data analysis.

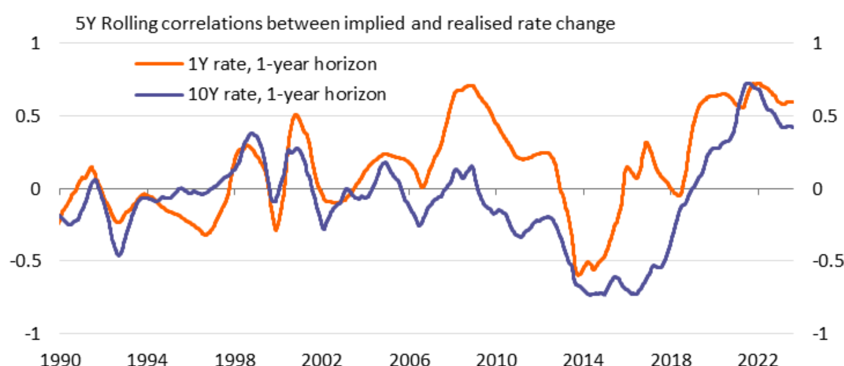
Forwards help predict rate moves for shorter tenors and terms

Correlation of implied vs realised changes (since 2000)

Forwards	Tenors: 1Y	2Y	3Y	5Y	10Y
1M	0.2	0.1	0.0	0.0	-0.1
3M	0.3	0.1	0.0	-0.1	-0.1
6M	0.3	0.2	0.1	0.0	-0.1
1Y	**0.3**	0.1	0.0	-0.1	**-0.2**
2Y	0.4	0.2	0.1	-0.1	-0.3
3Y	0.3	0.2	0.1	-0.1	-0.4
4Y	0.2	0.1	-0.1	-0.3	-0.5
5Y	0.0	-0.1	-0.2	-0.4	-0.5

Source: ING Calculations

Forwards have improved as a predictor of shorter tenors



Source: ING Calculations

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