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Rates: Breach of 3% ahead

We are not convinced that the rise in market rates is behind us, and at some point in the coming months, we anticipate the 10-year will breach 3%

Two to four year rates are back up to their 15-year averages

Since the banking crisis of 2007/08, we've been remarking on how low US rates have been compared to the historical average. For the first time since the banking crisis broke, we now find that rates in the 3yr and 4yr tenors are back to their 15yr average. Some of this, of course, reflects 'slow grind' falls in the 15yr average reflecting quantitative easing and the years where the funds rate was at zero (to 25bp). That said, the move back to average is worth noting.

10-year rates are still below the 15-year average

It is also important to contrast the convergence to average for 3yr and 4yr tenors with the fact that the 10yr is still some 60bp below the 15yr average and the 30yr is 120bp below. This, in turn, points to the vulnerable areas of the curve. The front end is facing expected Fed hikes and will ratchet up to reflect this as they are delivered. The bigger debate is on longer rates, and the answer will come from the inflation outlook.

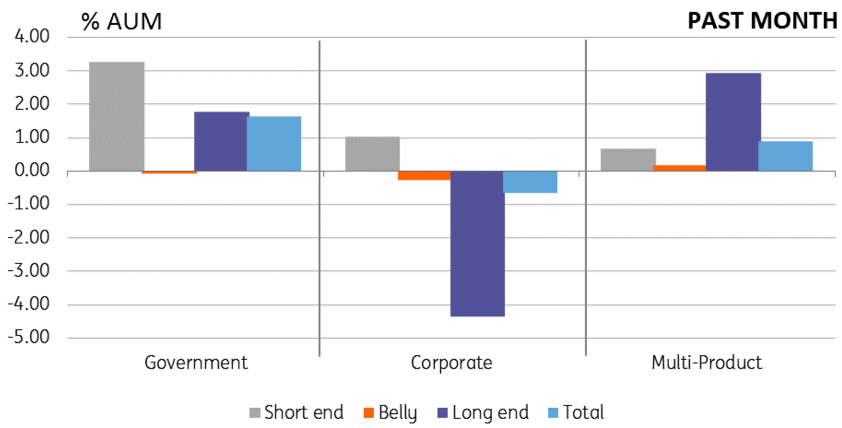
Fundamentals are still in tune with a further test higher in market rates

Energy effects will likely push the headline rate towards 3% in the coming quarters, from where it should then drift back down to meet the core which should land in the 2.2% area. The headline move will raise eyebrows, but the core move is key. Both will test resilience in long rates. The threat of a rising fiscal deficit ahead presents an additional headwind.

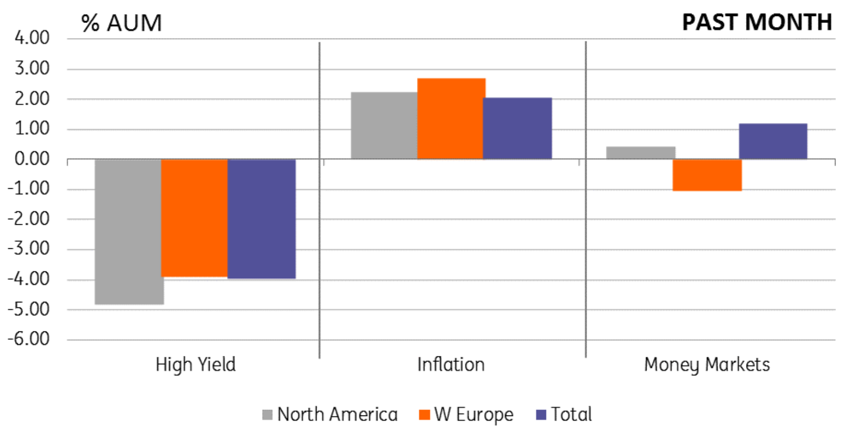
Investors have been taking advantage of higher rates, but we expect this to be temporary

We note that there has been some buying of long end funds in the past month, reversing some of the duration short that was set through January. Hence the failure to break above 3%, indeed the drift back (briefly) to 2.8%. We'd fade these tests lower in yield, as the structural theme remains in line with a test higher.

Changes in assets under management (Feb 2018)



Source: EPFR Global, ING estimates



Source: EPFR Global, ING estimates

We expect to see the 10yr re-test and breach 3% in the coming months

Bottom line, we are not convinced that the rise in market rates is behind us, and we identify continued vulnerabilities in the belly of the curve (5yr to 10yr). At some point in the coming months, we anticipate an attack on 3% for the 10yr, and our models suggest that the 3.25% area is a minimum threshold to be achieved.

We find that Euro rates are up due to higher US rates, and are still well below average

Euro rates have been dragged higher by US rates, and with the front end anchored by ECB policy, the curve has stretched further steeper – the biggest of the rise in rates has been in the 7yr to 10yr area. The big contrast with the US is that Euro rates are still some 200bp below the 15yr average.

The US-German 10yr spread will widen some more, before starting a long term tightening

The latter is a point of vulnerability, as at some point in the coming few quarters that gap (current vs mean and Euro vs US) should begin to close in a precipitous manner. Perhaps not something that is imminent, but certainly a theme to be positioned for as we progress through 2018, as it will almost certainly be upon us in 2019, as the ECB hikes the deposit rate first and then the refi rate.

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