

Rates: Real rates begin to diverge

Inflation expectations have converged between the US and the eurozone. So, the 10yr rate differential is driven by real rates. As the US 10yr real rate broke above zero this week, the German 10yr real rate remains at -2%. That 2% gap is what you see on the Treasury / Bund spread. Consequences? The rate hike door is far more open for the Fed than for the ECB



The US 10yr real rate is back in positive territory

Something important happened this week. The US 10yr real yield finally broke decisively into positive territory. The move looks and feels like a confident one, one that is signalling an end to negative real rates, and a move to sustained positive real (10yr) rates.

But higher real rates also represent a tightening in financial conditions. This is the classic conundrum of the economic cycle where big swings in positive momentum are often precursors to more troubling times ahead where real rates are forced lower as excess consumption morphs into higher savings. But that's for later.

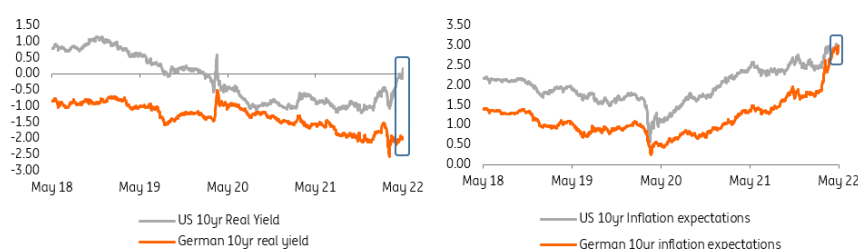
For now, the firming path is correlating with tighter financial conditions. The bulk of this so far has come from higher market rates feeding into wider retail and wholesale rates. As the Federal Reserve hikes rates, they are simply ratifying a path already being mapped out by the

marketplace, bolstering the tighter circumstances.

Eurozone real rate remains deeply negative, even as inflation expectations are at US levels

And in the eurozone, although the ECB has not even touched its rate hike trigger, financial conditions here have been perceptibly tightened too. Wider credit spreads, the likes of Italian yields under extra rising pressure, and large implied rate hikes discounted in market levels area are all contributing.

Real rates have diverged even as inflation expectations have converged (%)



Source: Macrobond, ING estimates

The 10yr real rate in, say, Germany is -1.8%. Deeply negative still. At the same time, 10yr eurozone inflation expectations are quite similar to US ones, in the 3% area. Long term inflation is elevated in both centres, but real rates remain down in the dumps in the eurozone. In contrast, real US rates have spiked.

So, what does all this mean? The biggest bond bear market in modern times has clearly tightened financial conditions. That is showing up in higher US real rates. But far less so for eurozone real rates. So, while eurozone inflation expectations are elevated, the real growth story is more nuanced.

It leaves the Fed behind the curve in terms of tightening. But it also appears to us that US market rates are close to their highs, even though the Fed is at the early stages of its tightening cycle. In contrast, the ECB has a path to hiking rates, but deep negative real rates point to a more careful delivery process.

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