

Rates Spark: a perfect storm

European curves react to higher energy prices and to news of fiscal support in the same way, by bear-flattening. More yield upside is to be expected when more spending is announced but at least a lot of the bad news is out already for gas supply



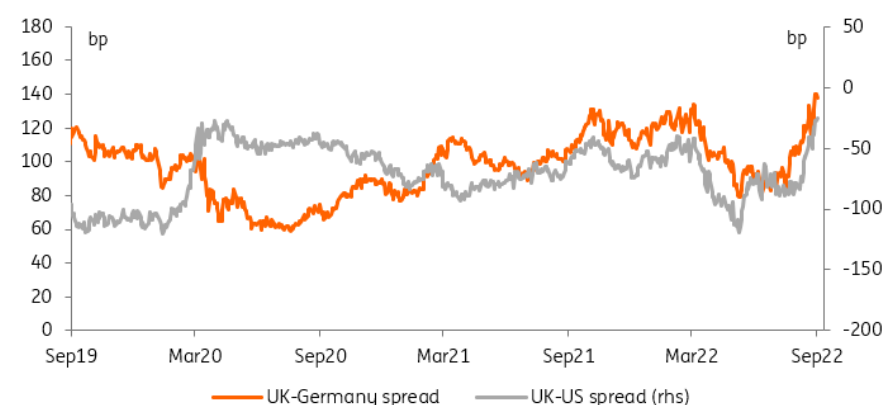
When fiscal gets involved

Even if it doesn't require further borrowing, rates markets immediately saw the hawkish implications to [Germany's third relief package](#). In keeping with ever rising European Central Bank (ECB) hike expectations, the prevailing view seems to be that any measure that limits growth downside would also free the central banks' hand in tightening policy further. There are actually few on the record comments to that effect in the eurozone but, in a period of hyper sensitivity to inflation, we wouldn't be surprised to see more yield upside as other governments unveil their own support packages. Remember that this cycle's high in 10Y Bund yields is only 20bp away around 1.77%.

Details on Truss' fiscal plans could amount to a reduction of uncertainty for markets

One potential exception to that rule may be the UK. The run-up to Liz Truss being announced as Prime Minister has been a very difficult period for gilts. We've written already of [the deadly combination of fiscal spending, monetary tightening, and foreign outflows for sterling bonds](#). The lack of clarity about the extent, funding, and inflationary impact of fiscal support during the leadership campaign may have exacerbated the sell-off in gilts. Actual details on her fiscal plans are starting to emerge, with Bloomberg reporting a potential cost of £130bn over 18 months to cap energy bills at £2,000 per household. In time, this could amount to a reduction of uncertainty for markets, and could be greeted with more stable performance for gilts.

10Y gilts have lagged international peers during the leadership campaign



Source: Refinitiv, ING

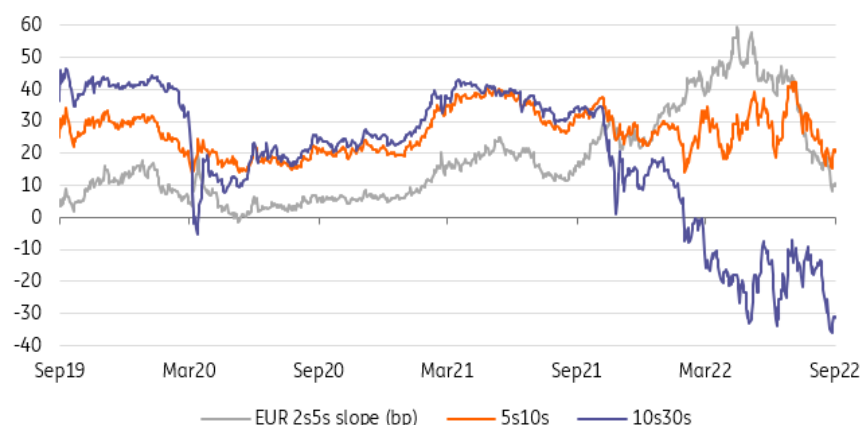
Central banks waiting in the wings

Of course, central banks have played a role in the market's sensitivity to fiscal headlines. The Bank of England (BoE) for instance has explicitly said more fiscal spending may force it into more aggressive tightening... but it could also be responsible for a further reduction in market uncertainty soon. Our, admittedly optimistic, take is that in addition to more details about fiscal measures in the coming days, next week's BoE meeting should also clarify its reaction. Paradoxically, the more hawkish the BoE, the more likely it is to regain a Fed-like degree of control on its domestic rate market.

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The market reaction to a full cut-off of Nord Stream gas flow from Russian is another place where central banks' hand can be clearly seen. The ECB for instance has encouraged market participants to think that it will react to realised inflation, most of which is energy-driven, rather than rely on its forecast. Fears of second-round effects also participate in this overreliance on energy price developments in rates markets. Even if we do think this may be an overreaction, this reinforces our view that [the EUR swap and German curves will invert this winter](#).

The whole EUR swap curve will soon be inverted, and the German curve is set to follow suit



Today's events and market view

Germany is scheduled to sell inflation-linked bonds and Austria will carry out auctions in the 3Y and 10Y sectors, but this will be eclipsed by syndicated sales from France (new 20Y) and Italy (new 13Y green bond), which we expect the price today. The duration impact should be non-negligible in illiquid markets but we surmise that this has been largely played out in the run-up to the deals. We wouldn't be surprised to see the curve flatten after pricing. The Italian sale comes in a context of a [shrinking greenium](#) across sovereign, sub-sovereign, supranational, and agency bond markets.

Data is on the light side in Europe with mostly construction PMIs from Germany and the UK to look out for. US PMI and ISM services should gather more attention. In particular, a decline in the price components would be greeted as further evidence that the Fed is on its way to meeting its inflation target. An improvement in the growth-relevant indicators might overshadow this however, with markets currently minded to take a hawkish implication to most releases and events.

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