

## Rates Spark: and then they hiked slower

The Fed delivered another 75bp of tightening but attention is turning to the end of this cycle. In Europe, German inflation could light a fire under the front-end but long-end rates seem determined to price the looming recession, with or without the ECB's help



The Fed raised rates by 75bp

### The peak in market rates is consistent with where the Fed now is in the cycle

Minimal market reaction to the 75bp hike. If anything inflation breakevens were a tad higher, but not much in it. Nominal rates are seeing little change in terms of impact effect. But the lead up to this has seen market rates fall, calming inflation expectations, pushing towards delivering on what was expected and no more. Meanwhile, the 5yr continues to richen to the curve, strengthening the turning point story for market rates, having set that peak at 3.5% for the 10yr a little over a month ago.

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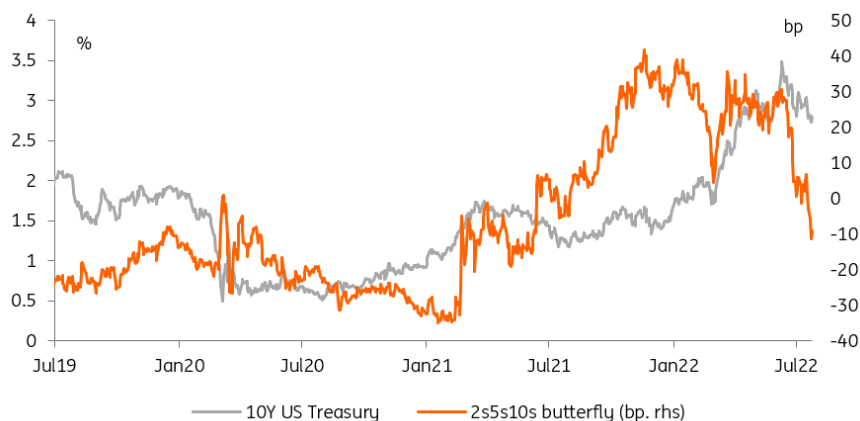
*The influential 5yr area is now signalling a turn in the cycle*

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We think market rates have peaked. Specifically, the 3.5% area reached by the 10yr Treasury yield

in mid-June was most likely it. We argue that it's not about the level per se. It's about the cycle, and the fact that the influential 5yr area is now signalling a turn in the cycle. Specifically, the 5yr yield is no longer sitting above an interpolation between the 2yr and 10yr (and trading cheap), but is now trading rich.

## 5Y coming in on the curve confirms that rates are looking to the end of this cycle



Source: Refinitiv, ING

This second 75bp hike from the Federal Reserve solidifies this, as it will further tame inflation expectations, which have really come down markedly in the past month or so. The recent 9.1% inflation print is noteworthy, but not pivotal. Inflation expectations matter more. The 2yr inflation breakeven (which incorporates the latest inflation) is now down to the 3% area, having been at 4.5% in mid-June (and 5% in March).

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*Inflation expectations have really come down markedly*

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In addition, post this FOMC the Fed has completed two-thirds of what we think it will deliver in total. Typically from there, the turning point is upon us. The US yield curve is under flattening pressure now as the Fed continues to hike. As the hikes begin to slow (which we see by the autumn), the next big move will be a steepening from the front end, as the curve begins to get ready for potential cuts at some point in 2023.

## German inflation to spur ECB hawks

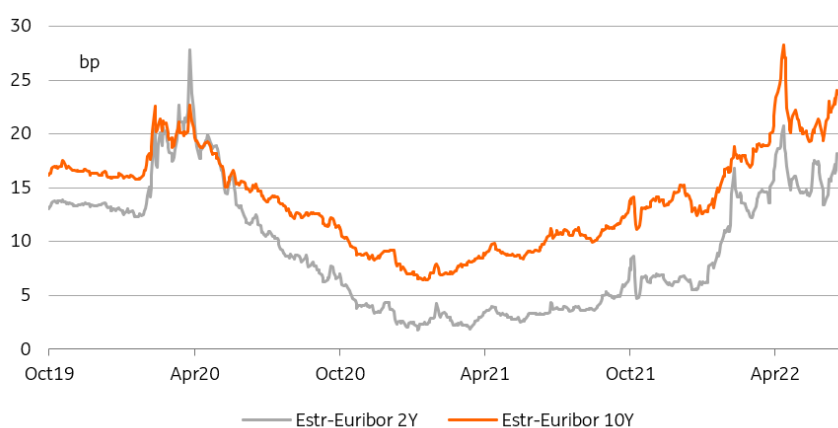
Inflation takes centre stage once again in European markets with Germany kicking off the July CPI releases today followed by other member states, and the eurozone-wide measure tomorrow. The ECB has barely started its hiking cycle and has just done away with years of negative interest rates policy (NIRP). We suspect the inflation peak in this cycle is ahead, rather than behind us, which in turn piles pressure on the ECB to keep up its hawkish rhetoric.

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## Central banks have lost control of the back end of the curve

Whether markets listen is another question altogether. It is possible that another upside inflation surprise lights a fire under the front-end, or at least prevents it from pricing out further hikes after the already sizeable drop these past two months. However, we are increasingly of the view that central banks have lost control of the back end of the curve, as recession fears boil over. This means that a more hawkish tone at the ECB could well be greeted by lower yields, as the ECB is seen as hiking into a recession.

## The recession is already tightening financial conditions for the ECB



Source: Refinitiv, ING

Some of the tightening of financial conditions the ECB is trying to deliver with its hikes is also happening with markets bracing for a recession. There are many indicators that illustrate this point. The widening of credit CDS indices is one, another is the widening of the Euribor-Estr basis. In both cases, they show that tighter financing conditions are feeding through to various corners of the economy and of markets, thus reducing pressure on the ECB to hike aggressively.

### Today's events and market views

Euro rates markets pick up the baton from the US as the focus turns to June inflation readings. A trickle of German regional CPIs will come out throughout the morning before the annual national number, which is expected to slow slightly, though the monthly one should accelerate. Our economics team thinks we haven't seen the peak in eurozone inflation in this cycle, keeping pressure on the ECB to get more hikes under its belt.

Italy will sell 5Y and 10Y debt in fraught market conditions.

Ignacio Visco is the sole ECB speaker on the schedule.

Hopes are that the June inventories and trade data released yesterday for June will help the US avoid a negative GDP print in 2Q, and thus a technical recession. Our own forecast is for +0.4% quarter-on-quarter. Market participants will also watch if jobless claims continue

on their uptrend and if the Kansas City manufacturing index follows other indicators lower.

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