

## Rates Spark: Balancing data and risk factors

Data sets the course for rates while risk factors surrounding the US banking tensions and the debt ceiling add growing noise. The case for lower rates is strengthening and US curves are behaving according to the end-of-cycle playbook. Like it or not, the ECB is part of the play even if it can't point to encouraging developments in underlying inflation



The [Bank of England hiked by 25bp yesterday](#) and the Governor has left the door open to further action. The inflation forecast that sees rates well below target two years from now is still surrounded by “significant upside risks”, and eventually rates will be “guided by the evidence”. Market reaction to the event was muted. The slight increase in the hike discount vanished with the releases of US data later in the session. Gilts did budge the curve flattening which unfolded later in US and EUR markets as headlines surrounding US regional banks weighed on sentiment.

## Data remains in the driving seat

Overall data has been one of the main drivers of markets and that state of play looks set to continue. After the payrolls data had made a hawkish case, the US CPI report and yesterday the producer price data have now supported a more dovish angle in providing more encouraging prospects for disinflationary dynamics to take hold.

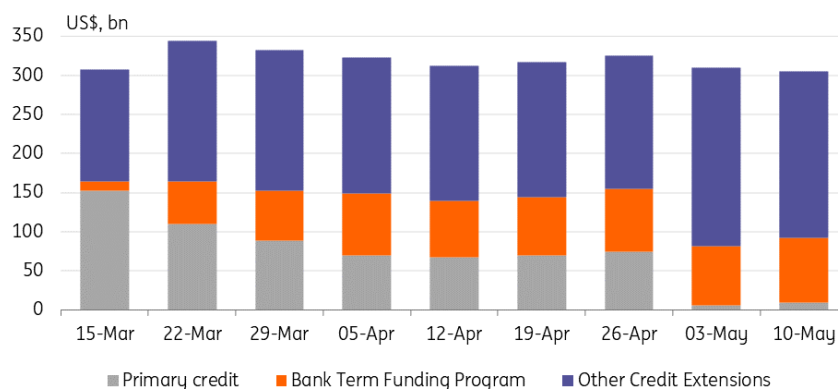
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*Banking turmoil and now the US debt ceiling add considerable noise*

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To be sure, headlines surrounding banking turmoil and now the US debt ceiling add considerable noise as both represent risk factors with potentially large impact on the economic outlook. Yesterday was a case in point and US regional banking stocks continue to trade on very subdued levels. The Fed's latest data shows that banks' borrowing from the central bank's back-stop facilities has inched up again, while money market funds are reporting further inflows signalling ongoing pressure on banks' deposit base as the Fed notched its key rate up once more.

## Recourse to the Fed's primary credit and term funding rises again



Source: Federal Reserve, ING

## Debt ceiling to gain traction as an additional risk factor

The Fed has not closed the door open to more tightening and officials have vowed to at least keep rates high for some time. Against that backdrop market pricing is starting to look extreme with a first 25bp rate cut more than fully priced for September and with cumulative cuts of almost 80bp before year-end being discounted. But this is taking into account the tail risks surrounding banking turmoil and of course the non-negligible risk of a US default event.

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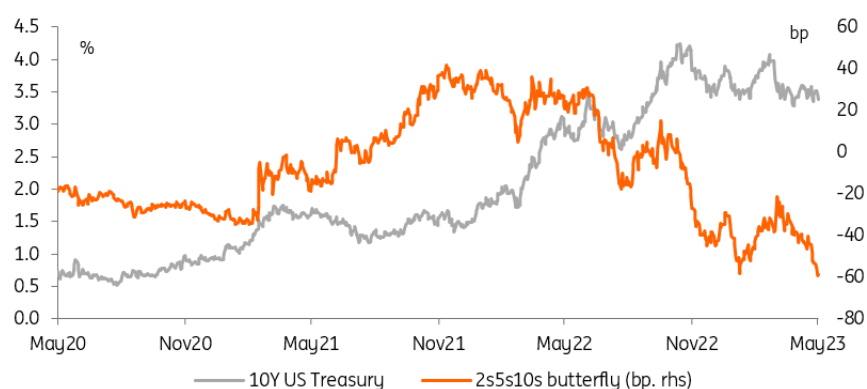
*US curves are behaving according to the established end-of-cycle playbook*

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When the Fed outlines its prospects it will do so around an assumed base case. For now the effective policy stance still remains relatively tight with real OIS rates well in positive territory despite recent declines, although in particular the 5y real rate has dipped below recent averages. For the Fed that does not signal a need to push a more hawkish line and allowing it to take a more balanced communication given the lingering uncertainties.

So far overall US curves are behaving according to the [established end-of-cycle playbook](#). While there has been noise around bouts of risk off sentiment, the 2s10s has more or less stuck to a sideways range since early March. However, the 5y point is clearly outperforming on the curve, hitting new cycle lows on the 2s5s10s butterfly spread as prospects of Fed rate cuts are on the rise.

## 5Y richening on the US curve is a sign of gloomy growth expectations



Source: Refinitiv, ING

## ECB hawks are pushing on a string

The underlying story in Europe over the past week has been that of constant hawkish noises from the European Central Bank. Unlike the Fed the ECB can't point to encouraging signs in inflation with the core rate remaining stubbornly sticky. Yesterday's ECB consumer survey pointing to notable increases in inflation expectations only strengthened the hawks' case, but overall the impact of the communications effort has arguably been limited. One home grown limiting factor has been softer eurozone economic data of late, but more importantly the ECB's fate remains closely tied to US financial sentiment.

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*The effective policy stance when measured by real rates has not changed dramatically*

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For now the market is still pricing one to two more ECB hikes by September, but from there on chances for rate cuts are increasing alongside US markets. On the bright side for the ECB hawks, the effective policy stance when measured by real rates has not changed dramatically. Along the curve real rates are not too far below their averages over the past two months even after yesterday's dip. From that standpoint the market pricing is perhaps not be as worrying to policymakers this time around.

Looking into the week ahead data will remain important, but we will not see top tier data as over the past two weeks. The US retail sales data is the highlight and there might be some focus on the housing data as well given the importance of the shelter component to inflation dynamics going forward. However, with US Treasury Secretary Yellen having flagged that the special measures to keep the US financially afloat could run out as soon as 1 June, the debt ceiling stand-off looks set to become an increasingly important factor for markets as well.

## Today's events and market view

Momentum currently favours the dovish case, also given the lack of top tier data next week. It may look like risks are more tilted towards the upside given how far pricing has evolved, but this will hinge on (positive) headlines surrounding factors such as banking stress and the debt ceiling.

In the end though, our own economists maintain the view that the lagged impact of past policy tightening and the worsening of credit conditions alongside prevailing banking tensions will see the Fed eventually cutting rates by 100bp before year-end.

As for today's events we keep an eye on US import prices and the University of Michigan consumer sentiment survey including its inflation expectations component. The US President and congressional leaders will also convene again today to discuss the debt ceiling, though there were reports this could be postponed to next week..

In the eurozone the focus will turn to Italy for a change, where bond spreads over Bunds have seen a gradual widening of late, to the top of this year's range since early January. Fitch is scheduled to review its BBB/Stable rating of the sovereign after European markets close. Fitch's review comes ahead of next week's review by Moody's, which has the sovereign on a Baa3 rating with negative outlook.

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