

## Rates Spark: Beneath the surface

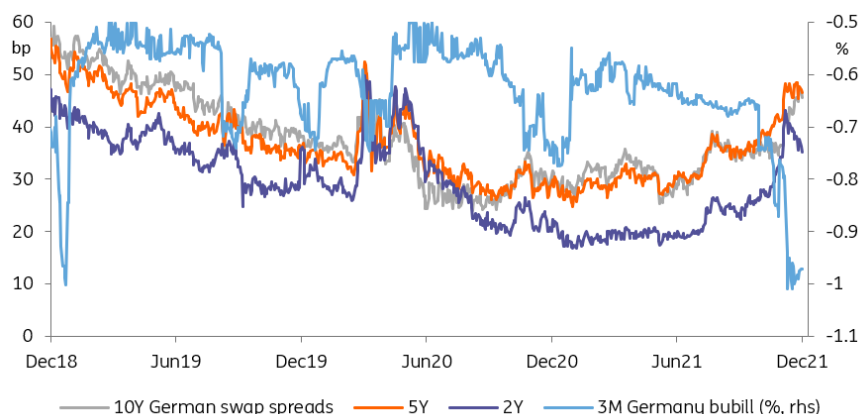
When one looks beneath the surface, the signs of improving sentiment in rates markets are more easily explained by hawkish central banks, or by technical factors. We think curve flattening is the most likely path forward in the near-term, whether or not we are right to doubt good omicron news.



### Rates are trading with a more upbeat tone, or are they?

We have started recent Rates Sparks with the warning that the newsflow regarding omicron might not be as good as reports of mild symptoms suggest. It does not look like the market shares this assessment, or perhaps it is simply a case of omicron fatigue setting in. ECB president Lagarde also chipped in with a balanced assessment in an interview yesterday, calling the new variant a manageable risk. Whatever the reason, some corners of fixed income markets are trading with a more upbeat tone, at first glance at least.

## The rebound in EUR T-bill yields explains in part the cheapening of swap spreads



Source: Refinitiv, ING

Take swap spreads. Their cheapening since peak Covid-19 angst in late November has been remarkable. Admittedly, the regaining of optimism has probably helped to ease demand for high rated core bonds, and thus reduce the rate differential with swaps. Fair enough, but it appears that the repricing has at least as much to do with easing of collateral scarcity, evident for instance in the rebound in EUR-denominated T-bill yields.

---

### *Swap spreads repricing has much to do with easing of collateral scarcity*

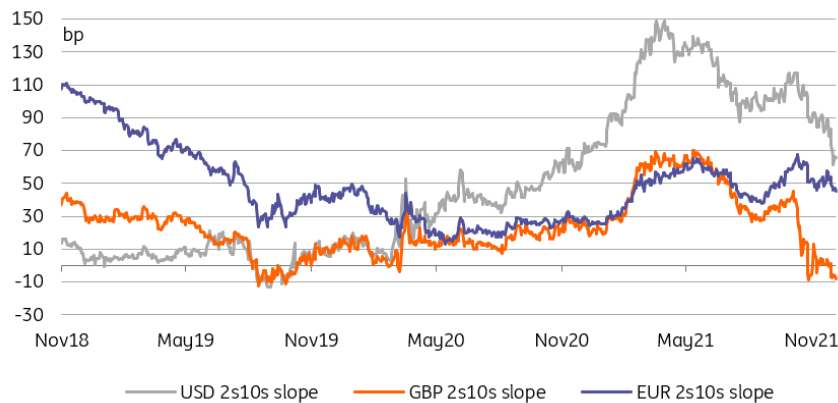
---

Another driver could be the dawning realisation that the risk of an abrupt withdrawal of ECB support measures needs to be included in asset valuations. This is possible, and indeed would be consistent with the re-widening of peripheral spreads. But we find that two opposite effects tend to offset each other to a large extent when it comes to core swap spreads. On the one hand, bonds cheapen collectively relative to swaps due to lower expected ECB buying, on the other safer core bonds tend to benefit from a flight to quality.

## Inflation is casting a long shadow

Curve movements are also instructive. An observer focusing only on the 10Y point could be forgiven in thinking that price action has mostly been sideways in recent days. In reality, yield curves have tended to flatten continuously through phases of omicron optimism and pessimism. We are more inclined to see the hand of central banks here, rather than real conviction about the direction of the Covid-19 pandemic, with the ECB repeating *ad nauseam* that it sees upside risk to its own inflation forecasts.

## Omicron optimism has only resulted in more curve flattening



Source: Refinitiv, ING

*Yield curves have tended to flatten continuously through phases of omicron optimism and pessimism*

This begs the question of when are upside risks so widely shared that they should prompt a shift higher in the ECB's main inflation forecast? The answer could be: when raising the official forecast would send too strong a signal of imminent tightening. A related explanation is that central banks are notoriously slow to turn so the current inflation messaging has to be taken by markets for what it is: a significant shift already. All this comes on top of the Fed's faster taper message still ringing in the ears of bond investors.

### Today's events and market views

Today is the last day ECB speakers can make public comments about policy before the pre-meeting quiet period kicks in. It doesn't look like they will miss the opportunity, with Lagarde, De Guindos, and Schnabel all scheduled.

Supply will consist in Germany selling 10Y bonds.

On the data front, the only item worth discussing is US job openings, although the picture of openings far outnumbering job seekers is not exactly new news.

As far as rates direction is concerned, we hesitate to jump on the omicron optimism bandwagon. Improvement in some risk assets is real but we share the bond market's caution. What seems more likely to us, is that yield curves continue to flatten on central banks' hawkish warnings, especially if the current Covid-19 wave ends up adding to their inflation angst as has now been suggested by officials from the Fed, ECB, and BoE alike.

## Authors

### **Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

### **Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.