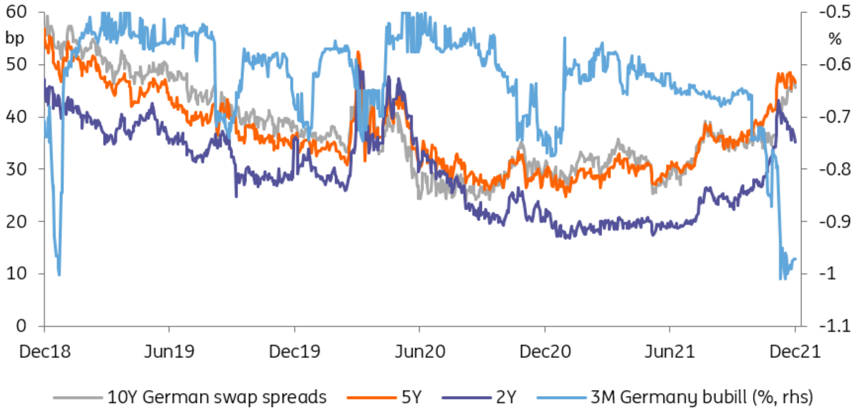
Rates Spark: Beneath the surface

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.

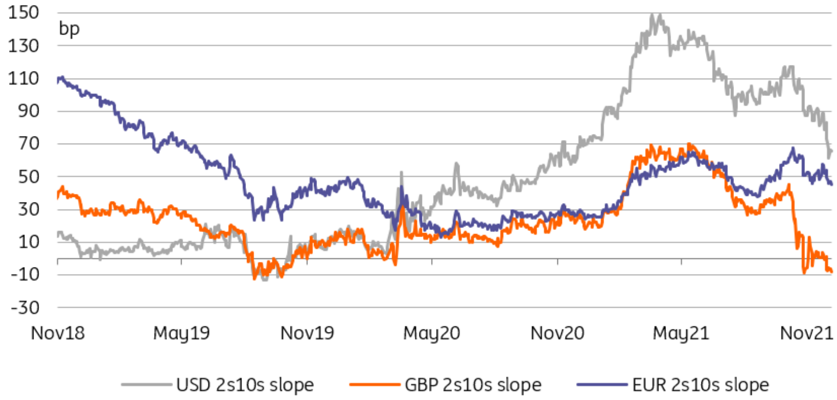
Swap spreads repricing has much to do with easing of collateral scarcity

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. One 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

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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.

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