Rates Spark: Bond bull traps

Bond markets face a number of bearish risks today, which have to be weighed against the underlying bullish tone. Look out for a strong ZEW, bond supply, and pre-BoJ positioning

Source: Shutterstock

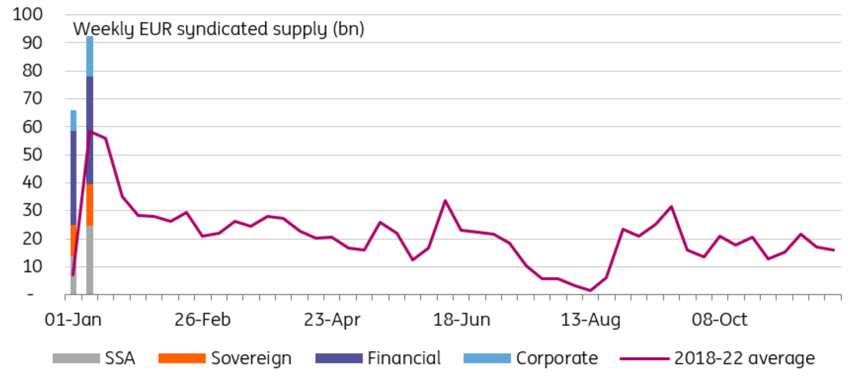
Bearish risks for a strong bond market

Germany's ZEW survey is the first potential banana skin in the European morning. As a survey of investor confidence, calling its direction is relatively straightforward: it should improve. The warmer-than-usual winter weather, reductions in gas prices, and surprising resilience of hard economic data all point in that direction. This is particularly true when compared to the gloom prevailing in the last months of 2022.

Bond supply so far this year has been well absorbed

Bond supply so far this year has been well absorbed by investors betting on declining inflation, and despite record-breaking volumes in the first two weeks of January (see chart below). However, occasional sovereign and corporate deals, especially the unswapped types, have tended to lead to temporary bond market weakness. Usually, these seem to have been bought into, like the morning sell-off in yesterday's session, but there is no guarantee that investors would do so today, especially given the event risks later in the week.

High bond supply so far this year hasn't caused yields to rise



Source: Bond Radar, ING

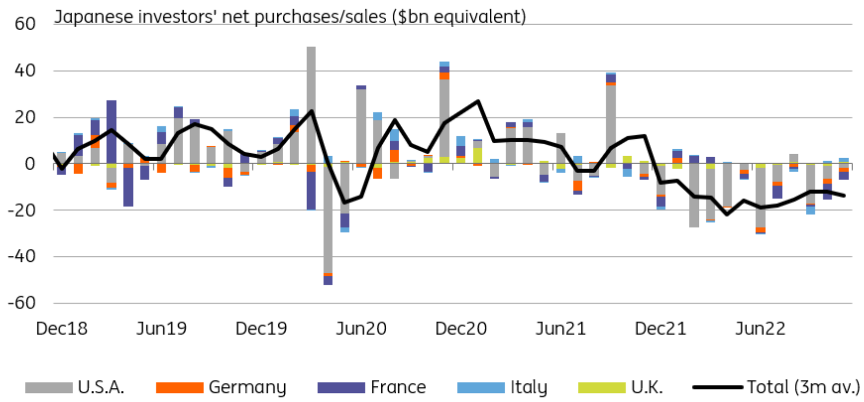
Last chance to position for higher JGB yields

This is particularly true due to the proximity of the January Bank of Japan meeting. Today is the last European and US trading session before a meeting where the Bank is increasingly expected to lift the 10Y Japanese Government Bond (JGB) yield target once more. Back in December, when that cap was lifted from 0.25% to 0.50%, 10Y Bund and Treasuries rose by roughly 50% of the sell-off in JGBs. Assuming a 25bp sell-off, one would expect European and US yields to jump by 13bp.

Consensus is increasingly shifting to a higher yen

With consensus increasingly shifting to higher yen rates - see for example 10Y swap rates hovering around 1% - this means the risk around the meeting is likely two-way, however. Shorting 10Y JGBs comes with a hefty carry and roll cost so a delay in shifting the cap higher may well result in short-covering. Note also that the steady selling of US and European bonds by Japanese investors in 2022 should reduce the foreign impact of higher JGB yields.

Japanese investors have sold foreign bonds over the whole of 2022



Source: Japanese Ministry of Finance, ING

Economic optimism isn't always good for bonds

All this has to be weighed against the underlying strength in bond (and other) markets evident since the start of the year (in fact since late October if one excludes the late December sell-off). At its heart, the 'everything rally' is driven by an improvement in macro conditions, especially by the belief that inflation is getting under control.

There is no obvious catalyst for a change of tone on today's calendar but note that investors could at any point wake up to the potentially inflationary consequences of some of the drivers of their economic optimism, for instance better European growth, resilient job markets, or China reopening. Two of these risks were highlighted by Bank of England Governor Andrew Bailey yesterday.

Today's events and market view

Germany's ZEW survey should be a good gauge of how much investor sentiment has improved. Based on the market reaction to lower gas prices and inflation, we would guess a lot. In the US session, the Empire Manufacturing Survey is the main release.

Germany is scheduled to sell €5bn 5Y bonds. Greece has mandated banks for the sale of a new 10Y benchmark,

John Williams, of the Fed, is the only central banker listed on today's calendar but the World Economic Forum, known informally as Davos after the Swiss mountain resort, is sure to produce a flurry of quotes from economic leaders.

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