Rates Spark: Bonds still trading at a premium

Markets are stabilising but implied volatility still shows lingering uneasiness leading up to the US CPI numbers on Wednesday. 10Y UST yields are trading lower relative to the front-end of the curve. Bonds may trade at a premium for longer as they fulfil a hedging and safe-haven role

US CPI on Wednesday one to watch in jittery market environment

Markets seem to be stabilising after recent gyrations. In rates markets, Federal Reserve cut expectations are stabilising at around 100bp of easing for this year, although that is still a level shift from around 60bp last month. However, indicators such as the VIX equity volatility measure – which failed to decline further yesterday – and still elevated implied bond volatilities suggest lingering unease.

Of course, the big data point people are looking at this week is the US CPI. Before its release, we will get the PPI indicator, and taken together with the CPI it should give markets a decent idea of what to expect later this month for the PCE, the Fed's preferred inflation measure. Expectations are for another set of benign prints, but after the weak jobs report, markets feel a little jumpier around data releases.

10Y UST yield slightly lower than front-end of curve would imply

We still think that the risk for rates points to the downside in the near term, especially if the data prints are benign, as rate cut speculation will stick and the actual first Fed cut approaches. What might limit the downside though is that at just over 3.90% for the 10y UST yield, there still appears to be a residual premium baked into rates after the recent events. Depending on the modelling parameters, levels are about 10bp lower than estimated from their relationship to the front-end of the curve, the latter still implying the Fed bottoming at a key rate somewhat above 3%.

It is not a huge premium – at around one standard deviation in the model – but the question is whether it will stick. That premium might come from bonds for instance displaying a negative correlation to equities during the recent gyrations, which means they have started to again fulfil their role as a cross-asset hedge. Another source of a safe-haven bid is the ongoing geopolitical tensions in the Middle East, where a retaliatory strike by Iran appears to be only a matter of time. Oil prices have crept up again, although they don't seem to have been driven too much by the headlines over the past months.

Today's events and market views

In Europe, the ZEW survey outcomes will be scrutinised for increased recession risk. In Germany, the numbers are expected to come in worse than last month, whilst consensus numbers earlier this year were more tilted towards optimism. The US publishes PPI numbers which form an important component of other inflation gauges. All readings are expected to come in at 0.2% month-on-month, which would be a number that helps pave the way for Fed rate cuts.

In terms of issuance, the UK will auction 13Y Gilts for £3bn, and Germany has scheduled 2Y Schatz for €5bn.

Author

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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