

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 jitterier 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.

Authors

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@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>.