Rates Spark: Bonds under pressure now but looking to cuts

Supply and a lack of adverse US headlines is keeping bonds on the back foot but appetite to break above recent yield ranges is weak. Instead, it appears that markets focus on soft eurozone data and prefer to listen to dovish guidance, when it doesn't extend out too far in time

Supply keeps bonds on the back foot, but still within their range

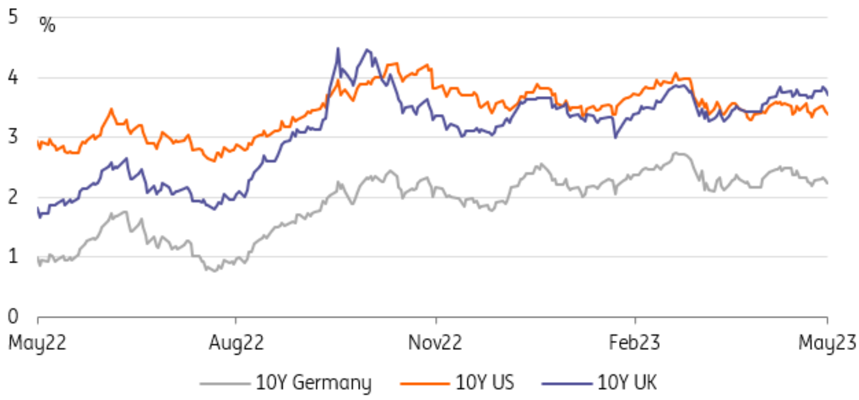
Bonds face an interesting combination of supply and improving sentiment towards the US regional banking sector. Debt ceiling angst, the third non-macro driver of bonds at the moment, is ever present in the headlines but we think their impact into broader markets, that is beyond money markets, is muted for now. This may not last. Risk appetite towards the banking sector is notoriously unstable, and the Fed's Michael Barr's testimony tonight may well put the issue back on the market's mind.

A return of optimism may well bring pent-up bond issuance to primary markets.

Barring another spike of banking worries, however, we think this supply window may well extend. Supply typically affects the market on a short-term basis. Selling pressure should in theory be front-loaded to the start of this week, but a regain of optimism may well bring pent-up bond issuance to primary markets, all to the detriment of secondary market bond direction.

A further tactical sell-off is our base case, although the top of the recent range in yield is approaching fast and we doubt there is enough risk appetite to justify breaking out of recent ranges, especially to the upside. It is true that our view, that the economy is heading for a hard landing which will force the Fed to cut rates, is now mainstream, but we doubt Treasuries have already run out of buyers. In fact, we think we're just about to enter a phase of banks and other institutions falling over themselves to call the date of the first cut. This should, to an extent at least, support the bid into Treasuries and send much of the 2-10Y maturities much closer to 3%.

Bond yields, especially treasuries, have been stuck in a narrow range since March



Source: Refinitiv, ING

A date with economic reality

Markets have a date with economic reality today, in the form of hard economic data out of the US, namely retail sales and industrial production. We doubt these will provide the smoking gun for the Fed to embrace market cut expectations (hence our bearish tactical view above). Instead, it is in Europe that hard economic data has proved the most relevant to rates direction. We credit, or blame depending on how one wants to look at it, them for market ignoring hawkish warnings by various European Central Bank (ECB) officials.

Investors seem more amenable to the dovish message

Instead, investors seem more amenable to the dovish message, that this hiking cycle will soon draw to an end. Yannis Stournaras was expressing this view as recently as this morning in an interview. Interestingly, consensus for today's German Zew is for a third consecutive decline in the expectations component, and the second decline in the current assessment since the index bottomed in October last year. It is hard to draw a conclusion on a single data point but it could be a case of market sentiment catching up to hard economic data, for instance dismal industrial production, rather than the opposite as intuition would suggest.

No wonder that markets are listening to the ECB doves more than to the hawks. A counterpoint to this is that it seems markets are getting numb to both sides of the argument, given the deluge of public comments made since the May meeting. For instance, MNI cited internal ECB sources as saying a September hike is viewed as unlikely. This runs counter to more hawkish press briefings. One reason for the lack of reaction might be that there will be two updates to the ECB's staff forecast by then, so policy opinions expressed four months before the September meeting are treated as just that, opinions.

Today's events and market view

Today's eurozone first quarter GDP is its second reading - this will be released alongside employment data. Italy's CPI release is also a final print. Instead, the focus should be on Germany's Zew survey, for an early read on May sentiment data. Interestingly, consensus is for a decline in both the current and forward-looking components, perhaps a sign that the softness in hard data is starting to catch up with too optimistic expectations.

The data calendar in the US session will be no less interesting, potentially more in fact. Retail sales and industrial production are the highlight, with car sales likely boosting the former. The NAHB housing market index is expected to stabilise at low levels after rebounding from its trough in December.

Belgium mandated banks for the sale of a 20Y benchmark via syndication which would add to the already scheduled 15Y auction from Finland.

There is a long list of Fed speakers on today's schedule, with a particular focus being Michael Barr's hearing on supervision and regulation. From the ECB, president Christine Lagarde is on the schedule but it's not obvious the event lends itself to policy announcements.

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