

Rates Spark: Bracing for more

Central bankers' hawkish response to indications of ever-stickier inflation have struck a nerve with markets which continue to ramp up rate expectations. But it is seen as the right medicine, with market-based inflation expectations dropping further while risk assets are holding up fairly well for now



Markets are increasingly bracing for the Fed upping the pace again

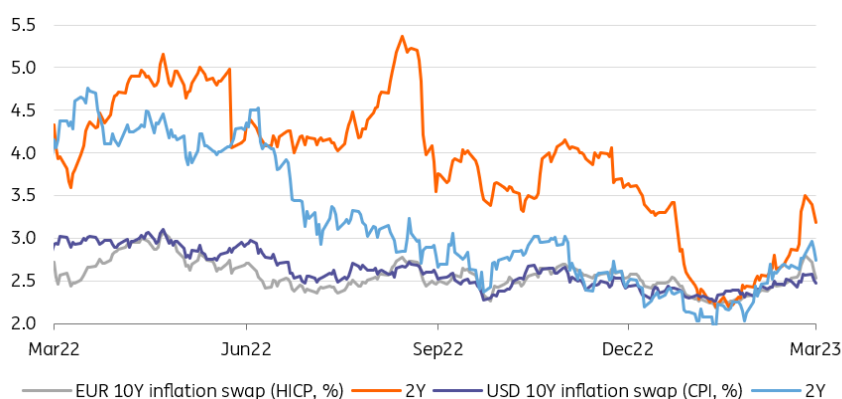
The US jobs data remains the key data point looming large at the end of this week, but that hasn't kept markets from further raising their expectation for a 50bp Fed hike yesterday. We think markets will need to see material evidence from Friday's report to row back after Fed Chair Powell opened the possibility of increasing the hiking pace again in his testimony.

Data in the meantime chimes with the narrative of a still tight labour market

Data in the meantime chimes with the narrative of a still tight labour market. The ADP payrolls estimate beat expectations, and job openings were reported in excess of 10.8 million yesterday, meaning that there are still around 1.9 openings for every unemployed worker. Today's eyes are on the initial jobless claims where a number below 200k would also give little evidence of the labour market cooling.

The US market is in the driving seat into the payrolls. While the front end has pushed higher, the back end is resisting to get back above 4%, thus further inverting the curve which is now stretching towards -110bp. That is not to say that investors are eager to pick the close to 4% in 10Y US Treasury yields. Yesterday's 10Y auction was in stark contrast to the stellar results of prior bonds sales this year, highlighting some unease ahead of the payrolls and also next week's key CPI data.

What the doctor ordered: Hawkish central banks are having the desired effect on inflation expectations



Source: Refinitiv, ING

Risk sentiment does not stand in the way of higher rates for now

If data does not stand in the way of higher rates, the other factor potentially capping the rise in longer dated yields especially remains risk sentiment. Clearly, the deep inversion of curves is already a reflection of concerns that central banks are overdoing it, but risk markets themselves are proving remarkably resilient in light of tightening already delivered and still expected.

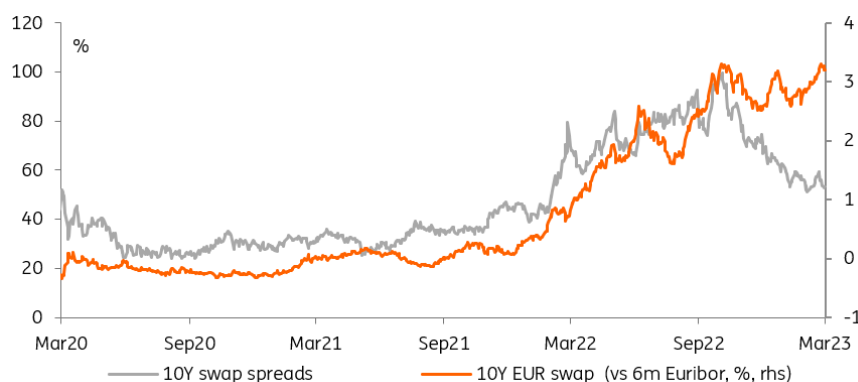
Italian spreads have withstood rising volatility and hawkish comments

In the eurozone markets the key spread of 10Y Italian government bond yields over German Bunds withstood rising volatility and hawkish comments. It has actually tightened and now resides below 180bp. This is even more impressive as just this week the European Central Bank's Holzmann has broken with the unwritten rule of not discussing the ECB's forward guidance on the reinvestment of Pandemic Emergency Purchase Programme portfolio, where a full reinvestment is currently still signalled at least until the end of 2024. Holzmann had suggested to include PEPP in

quantitative tightening this autumn. Recall that the possibility to flexibly reinvest PEPP maturities still is the ECB's easiest-to-activate first line of defence against any spread turmoil. Rolling off the portfolio could be seen as diminishing this firepower.

While measures of (implied) rates volatility have started to tick up again since late February, spreads that have before shown to be quite sensitive to such dynamics have indeed budged very little.

Collateral scarcity fears are no longer holding back Bunds



Source: Refinitiv, ING

The Bund spread versus swaps can also be subsumed under market risk measures, though it has become more of a measure of collateral scarcity fears since the ECB's pandemic interventions. And collateral scarcity really became an increasing concern with rising market volatility at the start of the broader market sell-off in 2022, driving also the directionality of the Bund asset swap spread – Bund yields had struggled to keep pace with the quick rise in swap rates.

Since then a lot has changed: The ECB and the debt agency have made more collateral available for lending, and especially last month the ECB has shown its sensitivity to the issue in the handling of government deposits on its balance sheet. Add to that the ECB's quantitative tightening is underway since this month as well. What we now see is that the directionality of the spread has been broken, and it is also budging the latest uptick in implied volatility measures.

Today's events and market view

Today's data calendar is fairly light with the highlight being the US initial jobless claims. The market is looking for a small increase in initial claims to 195k, which would still leave it below the pre-pandemic average of around 219k for 2018 to 2019. The key to validating current market pricing remains tomorrow's US jobs data.

After European bond supply from Ireland and the BTP Italia sale to institutional investors today, the focus in primary markets should be tonight's 30Y UST auction. It follows yesterday's weaker 10Y sale, although past 30Y sales have already stood out weaker compared to the strong sales metrics in the other maturities this year so far.

Late in the night, attention will turn to Japan for the last Bank of Japan policy meeting under governor Kuroda. Our economists note that he is well known for surprising markets, but believe that he will leave a decision on the future of the bank's yield curve control policy

to his successor Kazuo Ueda.

Authors

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@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>.