

Rates Spark: Champagne hangover

Celebrating the drop in German inflation may be premature and headwinds to bond performance, especially for those denominated in euros, remain. The Fed minutes might not fulfil all of the markets' dovish hopes



Keeping the bubbly in the fridge a little while longer

The characteristic 'pop' of opening champagne bottles could be heard across Europe when Germany's statistical office published a dramatically lower set of inflation figures for December 2022 than in the month preceding. More cautious investors may want to keep their bubbly in the fridge a while longer however, lest they face a rising tide of core inflation with the equally characteristic champagne hangover. [As our economics team noted](#), core inflation may have, if anything, accelerated last month. What's more, the government measures responsible for artificially capping inflation rates may also lengthen the time it takes for it to return to the 2% target.

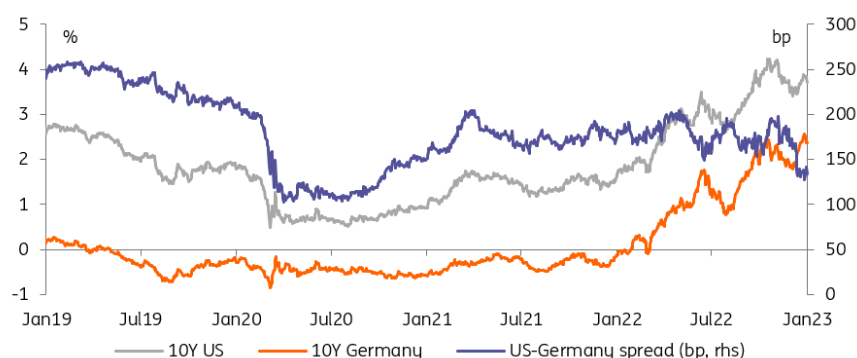
Core inflation may have accelerated last month

This makes us uneasy about the drop in market rates yesterday. Yes, 10Y Bund yields are still up more than 60bp since their mid-December trough, and many participants returning from a two-

week break may struggle to understand why yields have risen so much. To cut a long story short, the reasons centre on China reopening, Bank of Japan gradually raising the yield cap on Japanese Government Bonds, and European Central Bank (ECB) officials hammering home the message that more tightening will need to be delivered if inflation is to be brought back under control.

We would venture that December inflation data so far will do little to assuage their inflation fears, but perhaps better news awaits in the remaining inflation indicators to be published this week, starting with France today, and culminating with the eurozone on Friday.

Bund yields reached new highs in late December, and converged to Treasury yields



Source: Refinitiv, ING

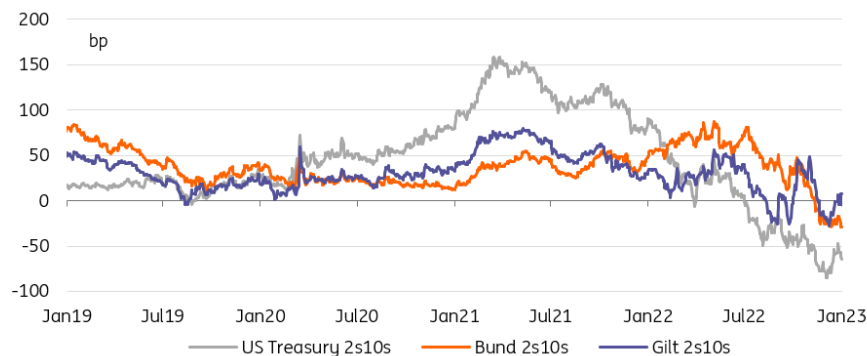
EUR rates the outlier

More than a jump in rates over the last two weeks of 2022, what is most notable is the underperformance of EUR-denominated bond markets. The hawkish shift at the ECB explains a great deal of the 10Y Bund bear-tightening 20bp to Treasuries and it was interesting to see Treasuries outperform Bund again on the day of the German inflation downside surprise. Upshot is: the convergence between USD and EUR rates is here to stay although we think the next leg will most likely be driven by a fall in USD rates once Fed cuts come into view.

The convergence between USD and EUR rates is here to stay

Speaking of the Fed, the minutes of the December meeting are published this evening. Chair Powell is increasingly understood to be one of the most hawkish members of the Federal Open Market Committee (FOMC) but after two subsequent slower inflation prints in October and November, markets chose not to heed his hawkish warning after the last meeting. The minutes will be an opportunity to test that assumption. In short, we think markets go into the release with dovish expectations, which means a hawkish surprise is more likely to move rates. Mind you, if the December meeting is any guide, market reaction should not be dramatic. This should also reduce Treasuries abilities to widen relative to Bund.

The US curve re-steepening is set to be one of the most notable moves of 2023



Source: Refinitiv, ING

And a brief synopsis of what we expect as we look through 2023

Despite the easing in inflation pressures, the first quarter will have a strong rate hiking theme. The Fed is still hiking and needs tighter financial conditions. That should force market rates back up. With the ECB on a hiking mission too, upward pressure on Eurozone market rates will also feature.

While we see resumed upwards pressure on rates dominating the first quarter, the biggest narrative for 2023 as a whole will be one of significant falls in market rates. The Fed and the ECB will peak in the first quarter, and once there, market rates will have a carte blanche to anticipate future cuts.

Larger falls for US market rates are projected later in 2023, reflecting likely subsequent Fed cuts. But with cuts less likely from the ECB, expect a relative steepening of the US curve versus the Eurozone one. This is a classic box strategy where the US curve steepens out (dis-inversion), and the Eurozone one re-steepens by less.

By the end of 2023, the US 10yr Treasury yield is back down at 3% and the Eurozone 10yr swap rate at 2.5%. But we should not go below these levels for long.

Today's events and market view

The events calendar is dominated by business sentiment indices. European services PMIs in the morning will mostly be second readings with the exception of Spain and Italy. French December CPI will follow hot on the heels of the (energy-related) drop in German inflation yesterday.

This will be followed in the afternoon by ISM manufacturing. Its price paid sub-index is now well below the 50 'neutral' level. Its fall since the second quarter of 2022 has been one of the indicators forewarning a slowdown in inflation. The employment component on the other hand has dipped besides still tight labour market indicators, although investors might interpret a further drop as an ominous sign ahead of Friday's US job report. Also on the topic of jobs, job openings will conclude the list of US economic releases.

The main event, however, is likely to be the release of the December Fed minutes (see above). There was a dovish bias in the market reaction to the December meeting and a

failure to confirm this hunch in the minutes is likely to send Treasury yields up.

In sovereign supply, Austria has mandated banks for the launch of a new 10Y benchmark. Germany is scheduled to sell 2Y debt via auction. KfW and EIB also mandated for 5Y benchmarks.

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