

## Rates Spark: Collateral damage

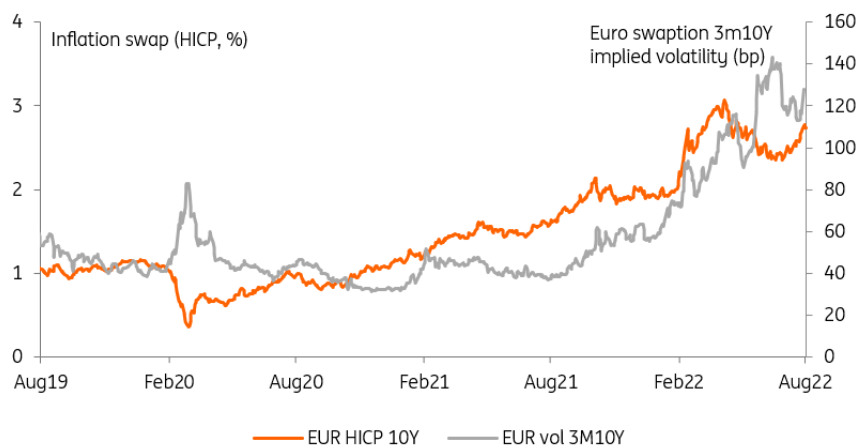
US hike expectations maintain upward pressure on US rates, although GBP and EUR hike expectations will in time appear self-defeating, but this will have to wait for energy prices to calm down. Green bonds are an unexpected collateral victim of worsening market conditions



### Worsening fundamentals for the bond market

Within the world of DM rates, it is fair to say that no bond is in favour at the moment. The rise in yields has been broad-based, and accompanied by a toxic rise in both implied volatility, and of market-based inflation expectations. The former suggest an eroding of government bonds' safe-haven status, the latter show the return to persistent inflation concerns. That inflation swaps rise even as markets are pricing a higher path for central bank rates is a worrying sign. It suggests that even more aggressive hikes will fail to get inflation under control.

## Higher inflation swaps and volatility are a toxic cocktail for bonds



Source: Refinitiv, ING

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*The simultaneous rise in hike and inflation expectations reflects the fact that a large chunk of inflation dynamics are beyond central bank control*

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Of course one should be wary of extrapolating a few days in illiquid markets, but the simultaneous rise in hike and inflation expectations reflects the fact that a large chunk of inflation dynamics are beyond central bank control. This is particularly true of energy inflation, insofar as it is driven by supply constraints. One can question whether this is true over long periods of time, but this is not the first episode of front-end rates and inflation swaps moving in unison this year. Together, they point to tough times ahead for financial assets, as they imply neither an end in central bank tightening efforts, nor an end in overheated inflation dynamics.

How do rates trade in that context? Higher. There will be a point where the amount of hikes priced by the GBP and EUR curves, respectively almost +250bp and +200bp within one year, will appear [self-defeating in the face of the looming recession](#). This can only occur after the initial phase of a jump in energy prices. Rising commodity prices, and in particular energy, suggest that this time hasn't come yet.

## US 10yr Treasury yield to remain above 3%, and likely edges towards 3.25%

The dive in the US services PMI to deepish contraction territory (44.1; 12% below the breakeven at 50) yesterday took US market rates off their day highs. Manufacturing though is still clinging on (51.3; moderate expansion).

Probably the right market reaction. Macro slowdown leaves less work to be done by the Fed. Macro

slowdown has been in evidence generally, so no massive surprise for survey data to confirm this. Having said that, when you look at prior recessions what you are really looking for are breaks below 45 for PMIs. In that sense the 44 registered from the services index is a worry..

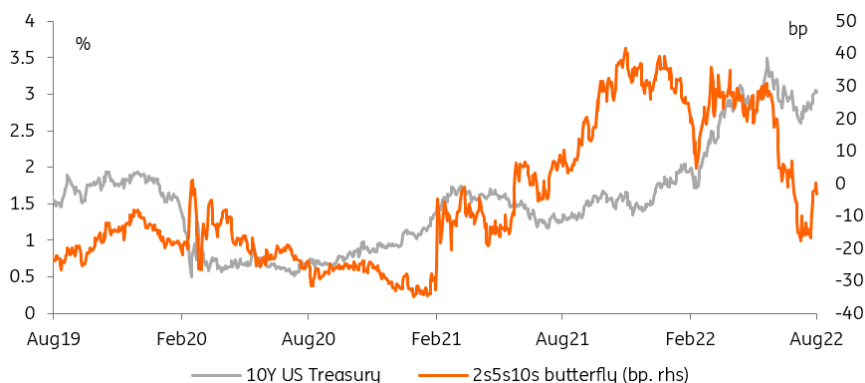
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*Its the manufacturing PMI that really drives sentiment*

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PMIs are strange though, as even though we know the economy is predominantly a services one, its the manufacturing index that really drives sentiment. It has a long track record, and has been better at telling us where the economy is heading. So far that part of the mix has not caved.

## The peak in the 2s5s10s butterfly also suggests the peak is in for 10Y yields



Source: Refinitiv, ING

Looking at the positioning of the 5yr to the curve, it's now approaching a more neutral valuation (just 2.5bp rich, having been as high as 10bp rich; or double that if looking at the gross measure). We're watching this carefully. So far it's valuation is still consistent with the turning point being in at 3.5% for the 10yr back in June.

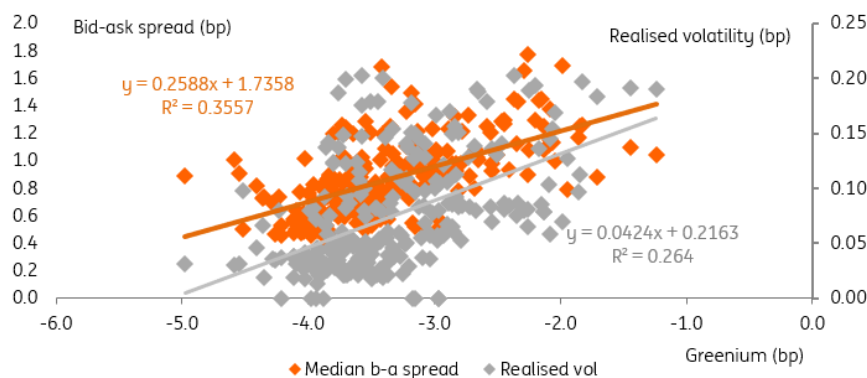
Any significant dip into a cheap 5yr valuation could stress this stance, and question whether that was the peak. We still think it was, as there is not enough evidence to negate that view at this juncture. Baseline view remains that we draft back up for the 10yr Treasury yield, heading towards 3.25%.

## Green bonds are a collateral victim of worsening market liquidity

With rates implied volatility jumping again, with energy prices pushing short and long-term inflation swaps higher, and with general liquidity conditions worsening, now seems like an appropriate time to illustrate the far-reaching consequences of this market regime. Higher rates have undermined the valuation of many assets with long implied duration beyond even bonds. The end of abundant liquidity has also drained demand from fringe speculative assets. But the worsening liquidity conditions have also affected an unexpected corner of financial markets, green

bonds.

## Shrinking German greenium can be traced back to lower market liquidity



Source: Refinitiv, ING

*In periods of low liquidity, the greenium tends to shrink*

Whilst we always agreed to the existence of a greenium, a tendency of green bonds to trade with lower yields than their peers, we have been frustrated to find [no uniformity in the way it is priced from a curve to the next](#). What's more the lack of correlation between greeniums within a same curve, or from one curve to the next, suggested to us that there is no such thing as a green factor. The retreating liquidity tide is changing that. Increasingly, we've observed that [sovereign and SSA \(sub-sovereign, supranational, and agency\) greenium is influenced by the liquidity conditions on these curves](#). In other words, in periods of low liquidity, the greenium tends to shrink.

This is an interesting conclusion as, despite expected deals from Germany, Belgium, and the UK this autumn, green bond supply is showing signs of stabilising after years of heady growth. It is too early to say if supply has finally caught up to demand but our analysis suggests less of a squeeze in the green bond market, and so it makes sense that macro factors such as liquidity start asserting themselves as day-to-day drivers of greeniums.

### Today's events and market view

Most of today's releases pertain to the US economy. A preliminary look at durable goods orders for July will be the highlight. Pending home sales are expected to decline further.

Germany will auction 10Y debt for €4bn in difficult conditions, although the yield pick-up compared to previous sales will no doubt be seen as an opportunity.

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