Rates Spark: Crucial levels ahead

Better data has boosted hawkish Federal Reserve and European Central Bank expectations. But this time, the back end of the curve has been lifted to a greater degree. In Bunds especially, the 10Y yield is now approaching the upper end of its recent range

Data steepens the curves from the back end

Rates were pressured higher on the back of the much better-than-expected retail sales data. A potential weather-related bounce in the data for January had been flagged though, and there is a decent risk that we will see some reversal again next month. For now, as noted in the chart below, money markets are seeing the SOFR rate above 5% through the end of this year for the first time. The notion of higher rates being maintained for longer is gaining traction.

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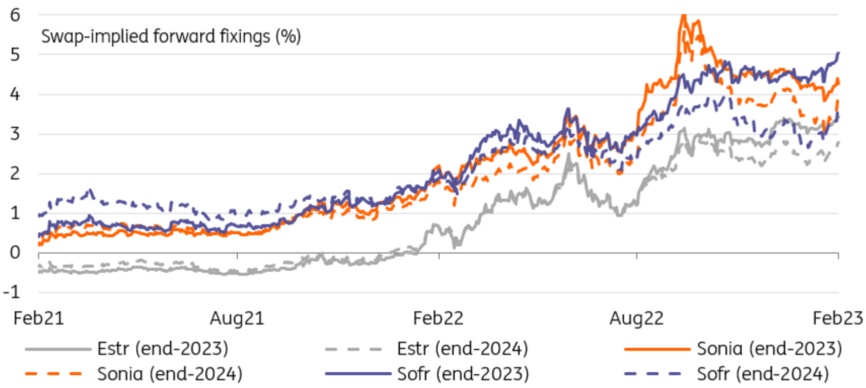
More notably this time round, it's the back end of the curve leading rates higher which also helped the Treasury curve pull back from its record inversion. The 10Y UST yield is now back above 3.8%

and thus not far below the local high it had ended 2022 on. That itself is still a decent stretch from the October high at over 4.30%, giving yields some room for further upside.

Of course, the size of the surprise in the data helps to explain the larger market reaction, but we think it speaks more to overall positioning in rates going into the past week(s) and also the stretched valuations in terms of the curve, which we have also highlighted over the past days. Note for instance that equity markets ended the day higher, dismissing the hawkish implications that the resilience shown in the data may have for the Fed.

Hawkish repricing pushes Fed and ECB expectations to new highs



Source: Refinitiv, ING

The ECB's hawkish message has finally sunk in

When ECB President Christine Lagarde addressed EU lawmakers yesterday she reiterated the call for another 50bp hike in March with underlying inflation still too high and price pressures remaining strong. But again she has left it to other ECB officials to flesh out any guidance beyond the next meeting. Following the last press conference, the central bank's hawks have been more vocal, and also quite successful at realigning markets more to their views.

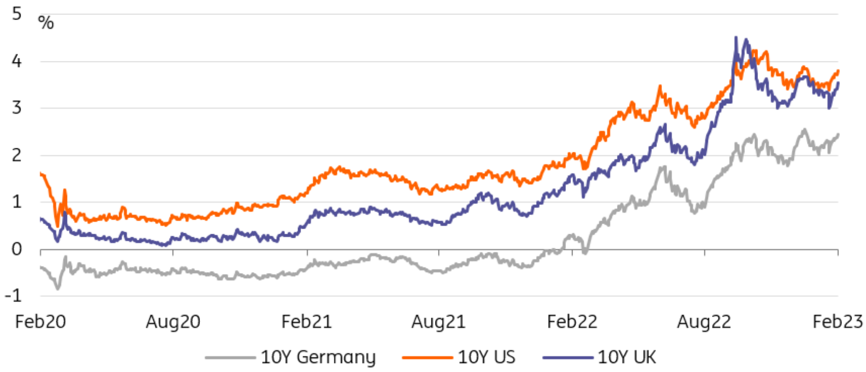
> *The terminal rate has risen ... and expectations of subsequent policy easing have become less pronounced*

The terminal rate has risen to 3.56% from a pre-meeting level of 3.44%, and the market’s expectations of subsequent policy easing have become less pronounced, down to below 90bp from the interest rate peak through the end of 2024. Financial conditions as measured by real rates are at the upper end of their recent range since December.

Our economists do see a possible scenario where, after March, the ECB continues to hike meeting-by-meeting by 25bp through June - this would bring the deposit facility rate to 3.5%. The market has moved even beyond that, but of course developments in the US have come to help the hawks and we doubt they would have achieved this feat on their own.

Today's slate of public appearances of ECB officials has a more dovish lean with Fabio Panetta and the ECB's chief economist Philip Lane scheduled to speak. With the Bundesbank's Joachim Nagel and Ireland's Gabriel Makhlouf, there are also hawkish voices again, but we have heard from both already more recently. In any case, we have the feeling that markets are more inclined to listen to data these days.

10Y Bunds are approaching a crucial level



Source: Refinitiv, ING

Today's events and market view

Market sentiment and positioning have favoured yield increases. But data remains crucial to carry the sell-off further, especially as we are approaching the upper end of recent ranges. Note that last night's 20Y UST auction saw good demand with the 20Y yield having briefly topped 4% just before. And in Europe, the 10Y Bund yield is now at 2.47%, not far from the (intra-day) highs of last October (2.53%) and December (2.57%) which stake out the upper end for Bund yields this cycle so far.

Today's data releases remain US-focused. Producer prices are seen decelerating further on an annualised basis, not standing in the way of the disinflation narrative. But in the wake of the strong payrolls data the focus will likely fall on the initial jobless claims to gauge the state of the jobs market. A heightened sensitivity to potentially changing narratives in other sectors of the economy may give more weight to housing data including today's housing starts after the larger bounce in the NAHB homebuilders index yesterday

Rounding off the data is a busy slate of central bank speakers. From the Fed, only Loretta Mester speaks during the European session, leaving the main focus on ECB officials, including the prominent doves Fabio Panetta and Philip Lane.

In terms of supply, we will see medium-term bond auctions from France out to the 7Y maturity for up to €11.5bn plus linkers and Spain auctions up to €6.5bn in bonds out to the 10Y. The highlight will be the sale of a new 30Y bond from Italy via syndication.

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