

## Rates Spark: Dancing to the energy market's tune

Hopes for a stabilisation in the euro bond market hinge on a further drop in traded energy. It is possible this was used as a pre-European Central Bank short-covering, but supply looms large in illiquid bond markets amid reduced risk appetite



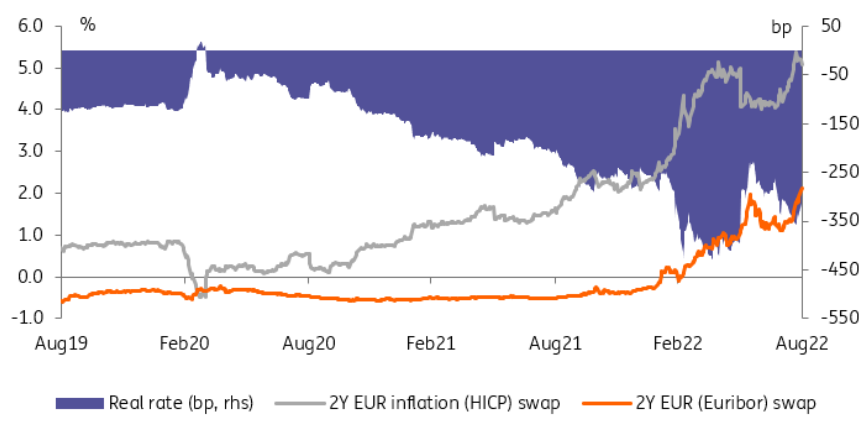
Eye-popping volatility in energy markets is making short-dated rates and bonds even more difficult to trade

### EUR rates rely heavily on daily energy price moves

European rates could have chosen a less volatile market than energy to follow the moves of, but such is the worry about European inflation. Whether the hope that above-target gas storage and energy market reform will actually durably deliver lower energy prices is a question we'll leave to our [commodity strategy colleagues](#). In the shorter run, the eye-popping volatility in energy markets is making short-dated rates and bonds even more difficult to trade.

By taking a leaf or two out of the Fed's book, the ECB has encouraged this state of play. Rightly or wrongly central banks are increasingly reliant on backward-looking measures of inflation, and their fear of second-round effects means energy inflation has greater-than-usual relevance in their decision-making. This line of thinking should probably not be pushed too far but in the current market environment, this is driving even higher volatility in the rates market.

## Short-end nominal and inflation swaps are dancing to the energy market's tune



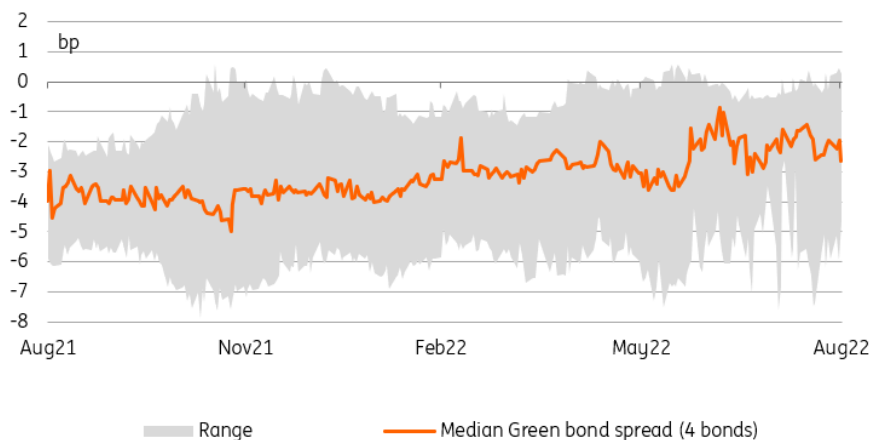
Source: Refinitiv, ING

## Supply looms large but so does a recession in Europe

Interestingly, the fall in energy prices has offered much-needed relief to the euro bond market, but this failed to translate into a re-steepening of the curve. Month-end maturity extension flow probably bears some responsibility for the back-end's performance but we see a more structural reason for a flat term structure, namely the deteriorating economic outlook. Barring a durable change in the trajectory of energy prices (and an immediate ECB change of tone seems unlikely), only the long-end is free to reflect Europe's less-than-rosy economic outlook.

It is also possible that this sudden fall in energy prices is used as an excuse for position-squaring ahead of next week's ECB meeting event. Anyone positioning for higher EUR front-end rates in August would have done well out of the recent move and has perhaps less to hope for in the difficult-to-navigate meeting. Until then, more traditional drivers of interest rates should reassert themselves. Borrowers issuing debt in these difficult markets should find that supply has a greater-than-usual impact on price action, with diminished market liquidity and lower risk appetite making a re-test of 10Y Bund yields above 1.5% a distinct possibility.

## Worsening liquidity conditions have pushed the German greenium closer to zero



Source: Refinitiv, ING

### Today's events and market view

French, eurozone, and Italian CPIs dominate today's economic calendar. Yesterday's slight downside surprise to the Spanish price index means expectations should mechanically be lower than the 9% YoY Bloomberg consensus for today's eurozone-wide release. Other European economic data include German employment and French second quarter GDP.

Germany will launch a new 5Y green bond via syndication which we expect to raise €5bn. [We noted last week that the shrinking greenium](#) was due to a worsening of liquidity conditions in the bond market.

US data will feature mortgage applications, ADP employment (published with a new methodology), and Chicago PMI. It will fall to Loretta Mester, Raphael Bostic, and Lorie Logan to labour the Fed's hawkish point. It is unclear whether they can and want to go above and beyond the message delivered less than a week earlier at Jackson Hole. What's more, we expect US rates to be in a holding pattern until Friday's job report tips the scales in favour of either a 50bp or 75bp rate increase in September.

Today is the last day of the month of August, and also the last opportunity for bond index trackers to rebalance their portfolios. This tends to be supportive of long-dated bonds.

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