

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



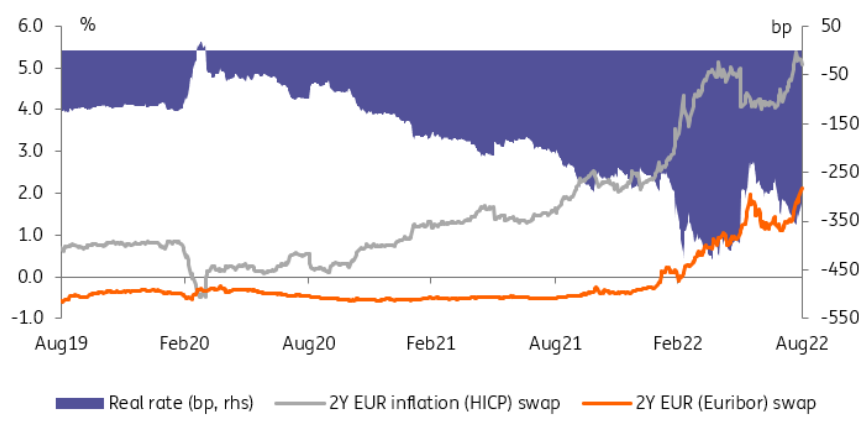
Eye-popping volatility in energy markets is making short-dated rates and bonds even more difficult to trade

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



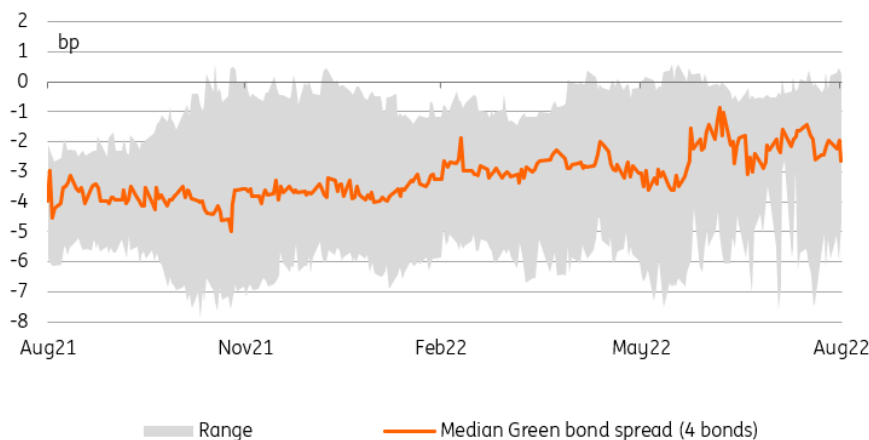
Source: Refinitiv, ING

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.

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>.