Rates Spark: No rest for the wicked

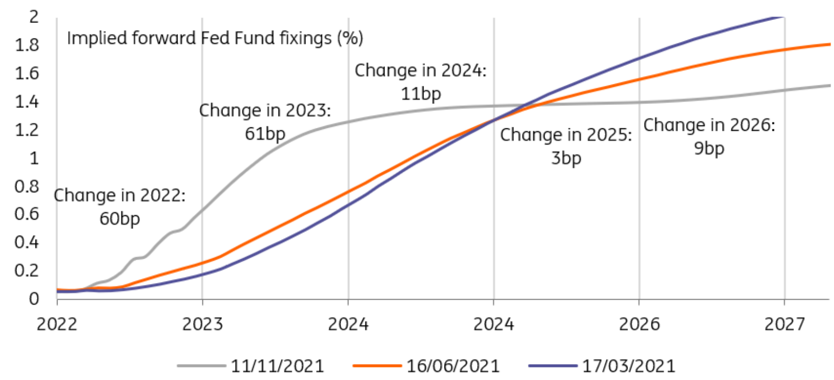
Closed US markets don't mean a pause in rates volatility today. BoE hike pricing is back at its most fanciful, and expectations seems to be for a more protracted cycle this time around. EUR bonds yields have decoupled from swaps, blame ECB tapering fears, but also a shortage of collateral. Oh yes, and US inflation is now runnning at over 6% - hot stuff!

US CPI - it still matters!

If bond yields had fallen on the back of yesterday's outsized CPI number (6.2% year-on-year) we'd have to ask some serious questions on the sanity of the market. In the event, market rates did very little to begin, but then caved and headed higher on the day. But as noted yesterday, a big CPI tells us nothing materially new. The bond market knows there is inflation.

And the fact that the number is some 30bp above expectations would usually, in days gone by, garner a much bigger reaction. But here, we also know that inflation is running at 100's of basis points above nominal rates, so what difference should an extra 30bp make. There was a reaction higher in breakeven inflation, and initially lower in real yield, but ultimately higher, and that's what drove nominal rates up in the end.

In spite of the CPI print, the terminal rate remains depressed



Source: Refinitiv, ING

Remember, CPI should in theory be a big driver, as inflation is a direct component of any nominal rate

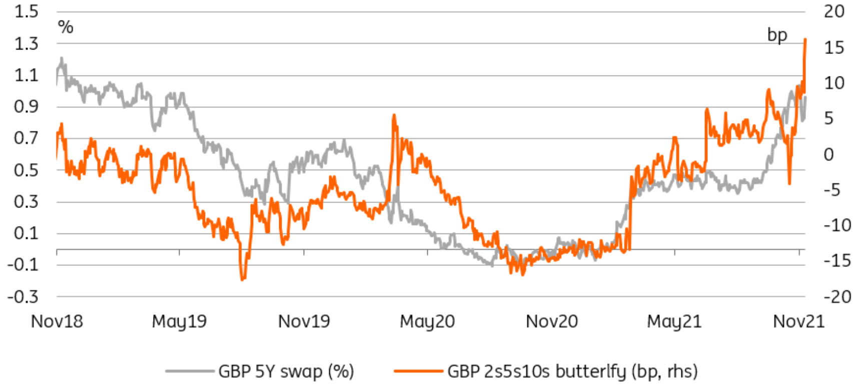
But still. Inflation has just not been the driver that it should be. Remember it should in theory be a far bigger driver than payrolls, as inflation is a direct component of any nominal rate. The bias should remain one geared to an edge higher in market rates, as tough a grind as it seems to be.

The belly has cheapened some more post the number – makes sense. And there has been a reaction higher on the 2yr yield; also makes sense. Both are in tune with an elevation in rate hike expectations and likely acceleration of delivery. It's just all quite tame, as is the 10yr reaction as it struggled to climb back above 1.5%, and the 30yr still in sub-2% territory. Stuck in mud, but trending higher again we feel.

Tremors in European markets

Today's US market closure offers a faint hope of less volatile market conditions but we wouldn't hold our breath. If The ECB's dovish message seems to have landed on EUR markets, contributing to a 're-anchoring' of front-end rates of sorts, they are not immune to global developments. Yesterday's US CPI was the latest illustration of how a foreign economic release could send markets in a tailspin beyond its borders. Despite the ECB's reassurances, the 5Y point is still close to being the most volatile on the curve. The same is true in GBP despite the BoE's decision to leave rates unchanged last week.

GBP rates have erased their post-BoE meeting drop



Source: Refinitiv, ING

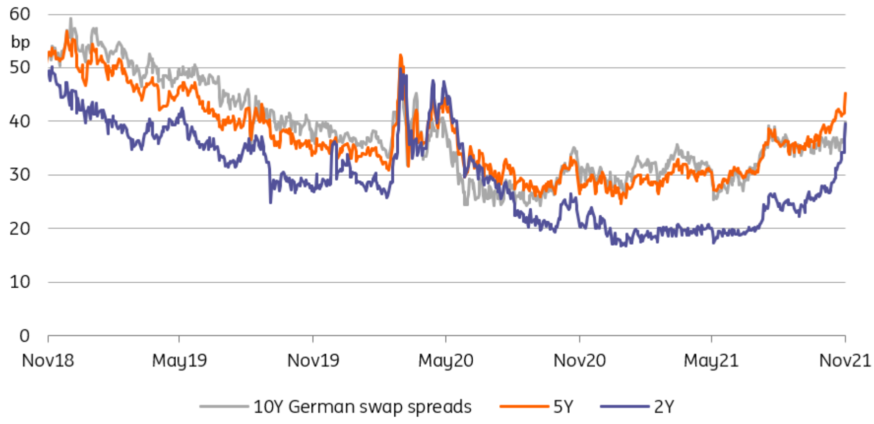
Markets start thinking of BoE tightening in terms of a protracted cycle

It is also worth noting that for all the solid performance of developed markets bonds since the central bank pushback last week, Sonia forwards are back to pricing a comparable degree of tightening to what they were discounting prior to the BoE's 'flip-flop' failure to raise rates. Here too, the same cause, the inflation scare, is bringing the same consequence, higher rates. It is worth noting however that this time around, intermediate rates, roughly speaking the 5Y sector, is where most of the action was. The GBP 2s5s10s butterfly, a typical forerunner of hike expectations, reached levels not seen since 2015, and may be a first sign that markets start thinking of BoE tightening more in terms of a protracted cycle rather than an aggressive hiking campaign.

EUR swap spreads: tightening fears and collateral shortage

There has also been plenty of distortions within EUR markets too. The widening of swap spreads across maturities can in part be explained by investors skittishness as the ECB moves closer to withdrawing monetary support, and may seem counter-intuitive at a time the balance of supply and demand is about to shift in a post-QE world. The truth is: investors have more immediate concerns, and we expect flight-to-quality demand to explain at least in part the persistently low German bond yields relative to swap rates. Note also that there is a seasonal dimension to bonds outperforming swaps into year-end, so any retracement might still be far away.

Bond yields have dropped relative to swaps, especially at the front-end



Source: Refinitiv, ING

> *We expect flight to quality demand to explain the persistently low German bond yields relative to swap rates*

A chasm has also opened between front-end and long-end swap spreads. The former have noticeably outperformed the latter even as ECB tightening expectations were pared back in recent days. Here, we think another factor is at play. A number of very front-end rates, for instance the repo on German securities, or the yields on very short-dated Bubills, has taken a plunge, indicating a cash glut or collateral shortage, or both. This fall in short German rates is propagating further up the curve into bond prices, while we suspect swaps are busy getting to grip with the odds of ECB hikes. The two aren't necessarily related, but they're pushing bond yields and swaps in opposite directions.

Today's events and market view

Today's liquidity conditions are likely to be sub-par due to the closure of US markets for Veterans Day, and bank holidays in other countries.

The main event on today's calendar will be the European Commission's updated economic forecast. This will come on top of a number of ECB speakers including Maklhouf, Lane, Schnabel and De Cos.

Today's bond sale menu include auctions from Italy (3Y/8Y) and Ireland (7Y/10Y).

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