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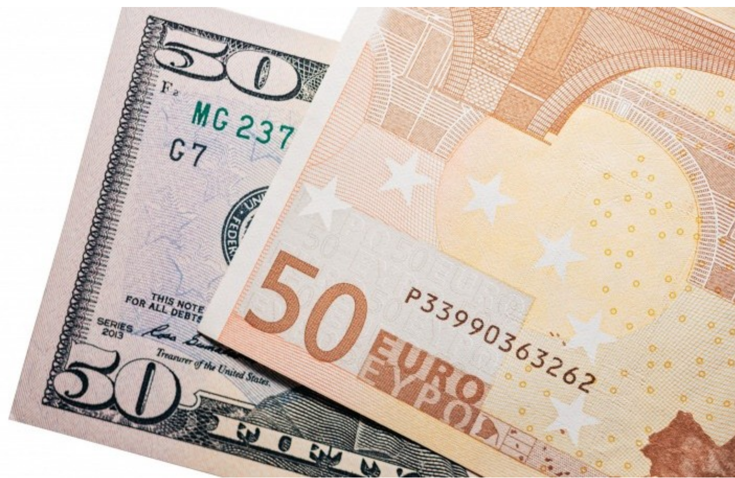
Article

Rates Spark: Drifty fifty

Federal Reserve and European Central Bank rate hike expectations of 50bp are firmly anchored for December, so bond yields continue to drift lower helped by short positioning. Weak PMIs and the Fed minutes should extend this rally, but we expect a retracement into next week



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Fed minutes and weak European PMIs to help the bond rally

Despite our expectations of bullish core bond price action this week, rates have hovered in a relatively narrow range so far: 8bp for 10Y Treasuries, and 11bp for the 10Y Bund. All this indecision might easily be explained by the lack of conviction to chase the bond rally lower in yields. If this is indeed the reason, we agree. Any further rally needs fresh economic news flow, in particular the kind that would

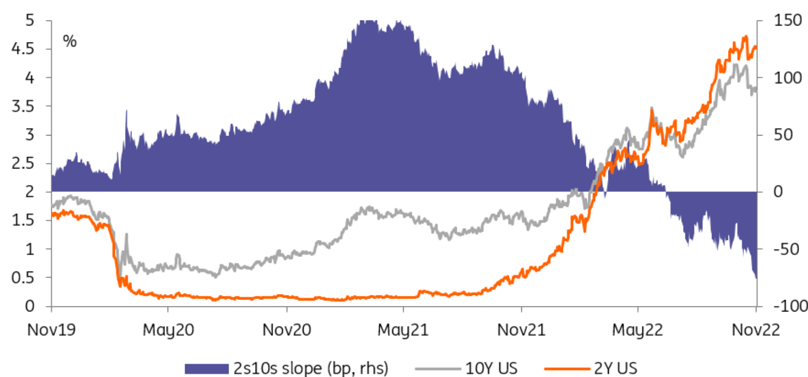
validate hopes of a more dovish path for base rates in the US and Europe.

We are loath to chase the move lower in rates

As much as we believe inflation will eventually converge with central bank targets, regular readers know that we are loath to chase the move lower in rates, knowing full well that the Fed and other central banks are at least two months' worth of data away from being able to allow financial conditions to ease. In the meantime, markets are vulnerable to a pushback from central banks, or simply to upside surprises in economic data.

This being said, today's releases could help the bond rally extend further. For one thing, European PMIs are expected to slide further into negative territory (ie, below the 50 expansion/contraction line). For another, we expect the market to pick out talks of a slowdown in the pace of Fed hikes in tonight's minutes and to spin them as a dovish signal. If we're right and the 'everything rally' extends, we expect valuations to become increasingly stretched, and liable to a reversal.

The US Treasury curve flattening seems driven by new 2Y shorts



Source: Refinitiv, ING

Short positioning increases and the ECB fails to move markets

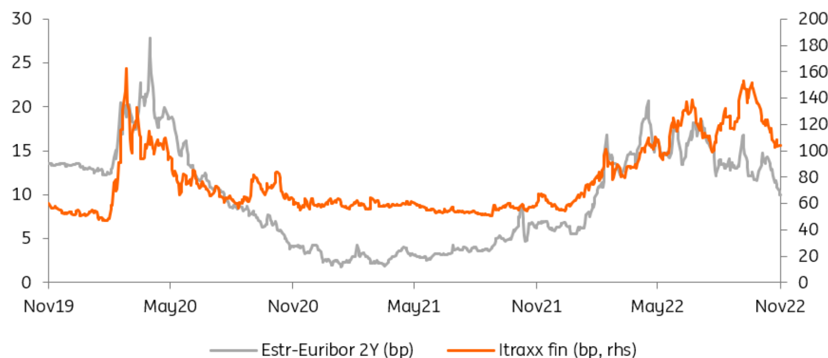
Now one should not underestimate the ability of markets to continue on the wrong macro trend, especially as liquidity dries up into year-end. Not that liquidity was great to begin with. In an environment where macro uncertainty is great, and the temptation to reduce risk into year-end is growing, we expect rebalancing to remain the key driver of price action. Looking at the CFTC data, positioning in bond futures is still short overall, and the short base has been increasing in the 2Y and 5Y. futures This suggests that the front-end underperformance relative to the 10Y, in other words, the curve flattening, has been driven by new shorts, but is increasingly

stretched.

We expect rebalancing to remain the key driver of price action

There is no shortage of central bank comments but they have so far failed to change market expectations. Despite a feeble attempt by ECB hawks to talk up the odds of a 75bp hike in December, market consensus is firmly set on 50bp. Even talk of a start to quantitative tightening (QT) in early 2023 has been met with a shrug. One potential explanation is that market participants doubt the hawks will get their way. Another, complementary, explanation is that a key detail is missing: how quickly will the balance sheet reduction occur. Most would assume a reinvestment cap that will be lifted very progressively throughout 2023, but there has been little by way of information on that front so far.

Risk assets have shrugged talk of a QT start in early 2023



Source: Refinitiv, ING

Today's events and market view

The economic calendar livens up today with a first look at November European PMIs, with most expected to fall deeper below the 50 expansion/contraction line. Services are expected to remain a relatively bright spot.

There is a non-negligible number of ECB speakers on today's slate, including Luis De Guindos, Pablo Hernandez De Cos, and Mario Centeno. Based on their previous comments, there should be a dovish tilt, thus reinforcing our bullish bond view for today. UK market participants will look for comments on the part of Chancellor Jeremy Hunt and Bank of England Chief Economist Huw Pill.

Germany will hit primary markets for the second time this week, this time with a €1bn 30Y auction.

The US economic calendar is no less lively thanks to mortgage applications, durable goods orders, jobless claims, PMIs, University of Michigan consumer

sentiment, and new home sales. All these will act as a set-up for the minutes of the November Federal Open Market Committee meeting, which we think will be spun as less hawkish than Chair Jerome Powell's press conference, and thus add to bullish bond impetus.

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