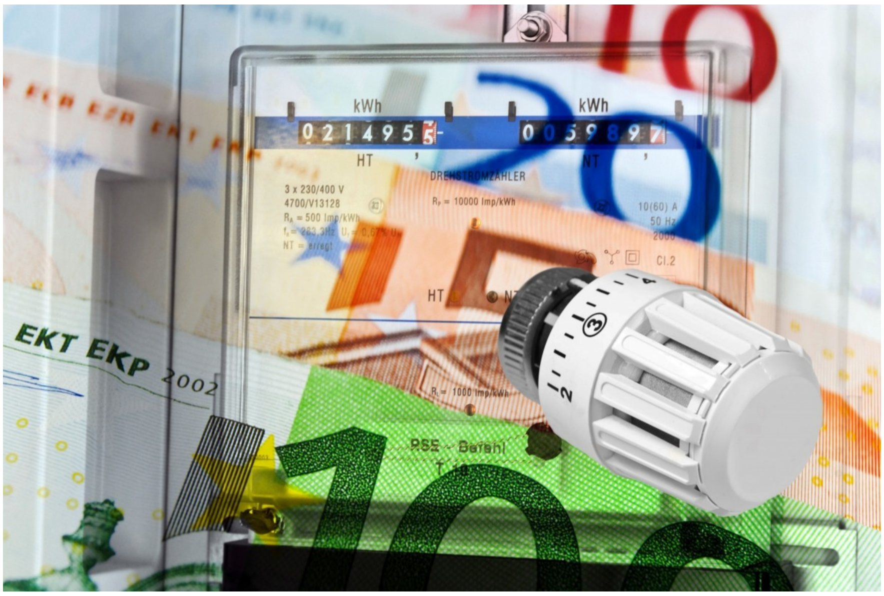
Rates Spark: Energy policy goldilocks

Falling energy prices are a key downside risk to European rates. Hawkish central banks and fiscal policy mean a further jump in yields is possible, but this may bring forward the bond rally we expected for late 2022/early 2023



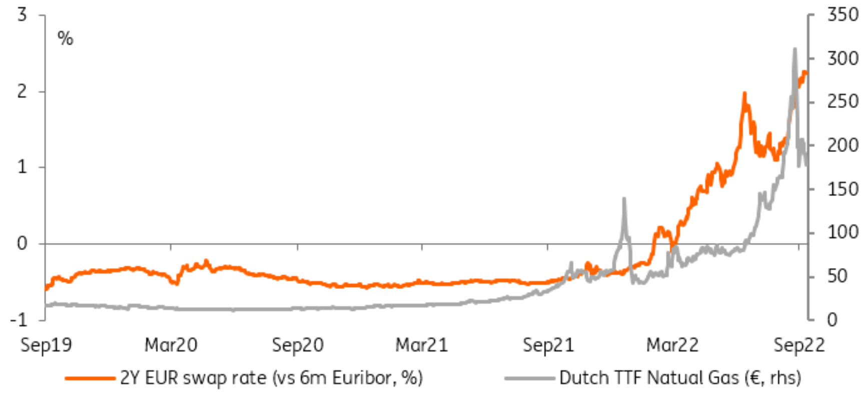
Eye-popping volatility in energy markets is making short-dated rates and bonds even more difficult to trade

The plunge in traded energy prices continues

The European Union's proposed energy market reforms and consumption curbs managed to draw a line under the continued climb in both traded gas and electricity prices. The impact has been nothing short of spectacular, especially as it occurred in the midst of a gas supply worst-case scenario, a total cut-off of the Nord Stream flow. We've highlighted recently that a continued fall in energy prices constitutes a key downside risk to European rates, in EUR and GBP. That downside is growing.

From the point of view of rates markets, the (tentative) reaction has been as close as one would expect from energy policy goldilocks: not too effective economically that it provides cover for central banks to hike further, but effective enough that it does allow energy prices to drop. Of course, between the two effects, the drop in energy prices may well be the one that impacts rates the most, but this is far from a foregone conclusion. Central banks are now overtly worried about second-round effects, a de-anchoring of inflation expectations, and a broadening of inflation – all of which could justify a continued hawkish tone.

Short EUR rates haven't yet reacted to lower gas prices



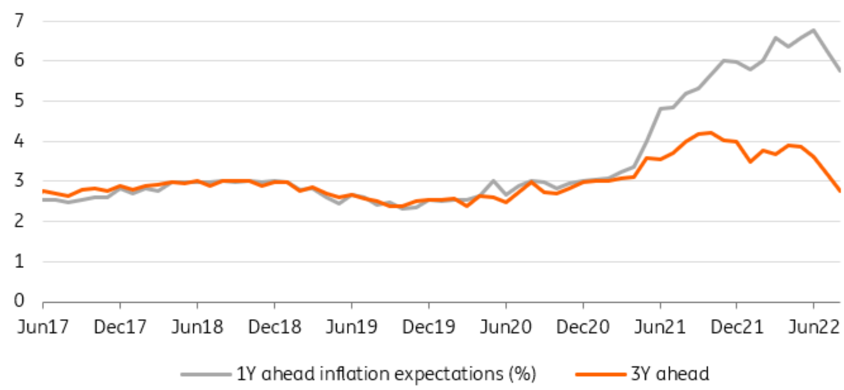
Source: Refinitiv, ING

Bonds remain shaky but the next rally may occur earlier than 2023

The main takeaway from last week's European Central Bank meeting for EUR rates markets is an updated, more hawkish, ECB reaction function. The ECB seemed to have taken, indeed ripped, more than a few pages out of the Fed's book. The upshot is that markets should, and have to a large extent already, concluded that euro for euro, the central bank will deliver more monetary tightening if energy prices rise further. We'll leave it to our economics colleagues to discuss whether this is the right approach going into a recession but we share their scepticism.

The upshot is that a jump in energy prices has so far impacted rates to the upside, but not to the downside. Nothing is set in stone and the further they drop, the more likely they are to take rates with them. For now, we stick to our view, also motivated by the strength of the US economy, that upside risk dominates for bonds. This is particularly true in an environment of fragile investor sentiment and rising supply, as is customary in September and October. If confirmed, however, the milder inflation picture would precipitate the rally in government bonds we expect for late 2022/early 2023, through 1% in the case of 10Y Bunds.

Falling inflation expectations are another challenge to the Fed's hawkish stance



Source: New York Fed, ING

Today's events and market view

Today's eurozone CPI are final readings of the August prints, and so are less liable to surprise, but the forward-looking Zew components should be a good indicator of market sentiment. It'll be interesting if the drop in traded energy prices and various measures taken to shield customers register in the market mood. Judging from the improvement in risk assets this month, we would say they have.

The main fireworks will come from the US, however, with the August CPI report. Consensus, and our own view, is for a drop in headline inflation, but a rebound in core.

How markets react to these mixed messages is an important question for rates over the coming weeks and months. The Fed has pushed aggressively against any dovish interpretation of one CPI report in July so a drop in rates and re-steepening of the curve would be notable. The drop in consumer inflation expectations published by the New York Fed yesterday was another challenge to its hawkish stance. The National Federation of Independent Business small business optimism completes the list of releases.

Primary market activity will take the form of 3Y/7Y/24Y auctions in Italy, a 2Y debt sale in Germany, and of dual-tranche 5Y/30Y European Union syndication which could raise upwards of €10bn. In the US session, a 30Y T-bond auction is a highlight. Note that 3Y and 10Y auctions already took place yesterday, meaning a lot of supply pressure has already been felt in USD markets, however demand was soft.

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