

## Rates Spark: Equities are back, but bonds are not - why?

US equities and credit have almost entirely recovered to prices from February despite the surge in energy costs and a significant tightening of financial conditions. The positive market sentiment could push up longer rates in the near term, but we remain more downbeat about the medium-term growth outlook



Expect market yields to remain elevated as energy prices remain high, but yet US equities are close to recovering to previous record levels

### The markets and the war and bond yields

To understand the market thinking on the war requires an understanding that markets are cold-hearted. The fact that negotiations broke down over the weekend is important, of course, but it's not the dominant input for markets. Wars between regional powers are not important for global markets. What matters is the ability to get stuff done, and to get hands on stuff. Last week, Iran had control of the Strait of Hormuz. This week, it's under the control of the US. While remaining a-political, that's a more market-friendly outcome, on the theory that the ultimate ambition is to re-open the Strait, fully and unrestricted.

The impact reaction is more nuanced, as in fact the US intervention mutes flows, certainly from Iran. But the bigger and longer term picture is more palatable. From a cold market mindset, even if Israel and Iran were to lob munitions at each other, markets won't care. Markets will care if the US is in the game, and ramping up risk. As it is, it seems that the US prefers an off-ramp, as long as it comes with the US taking control of enriched uranium, and the Strait gets fully re-opened. Things

could change quickly in the coming days, but based off what we know, there has been a landing found in an uncomfortable spot, but in an area that averts a super-bad-case outcome.

Expect market yields to remain elevated though, as the elevation in energy prices, even if off highs, has been far from solved. Inflation breakevens *have* managed to ease lower in short tenors, reflecting that mild ratchet away from extremes. But longer tenors yields have come off highs mostly from an easing in real yields. The market is beginning to think about a medium-term activity hit. That said, we continue to view the inflation spurt as the immediate issue that bonds will continue to fret over, keeping long tenor yields elevated.

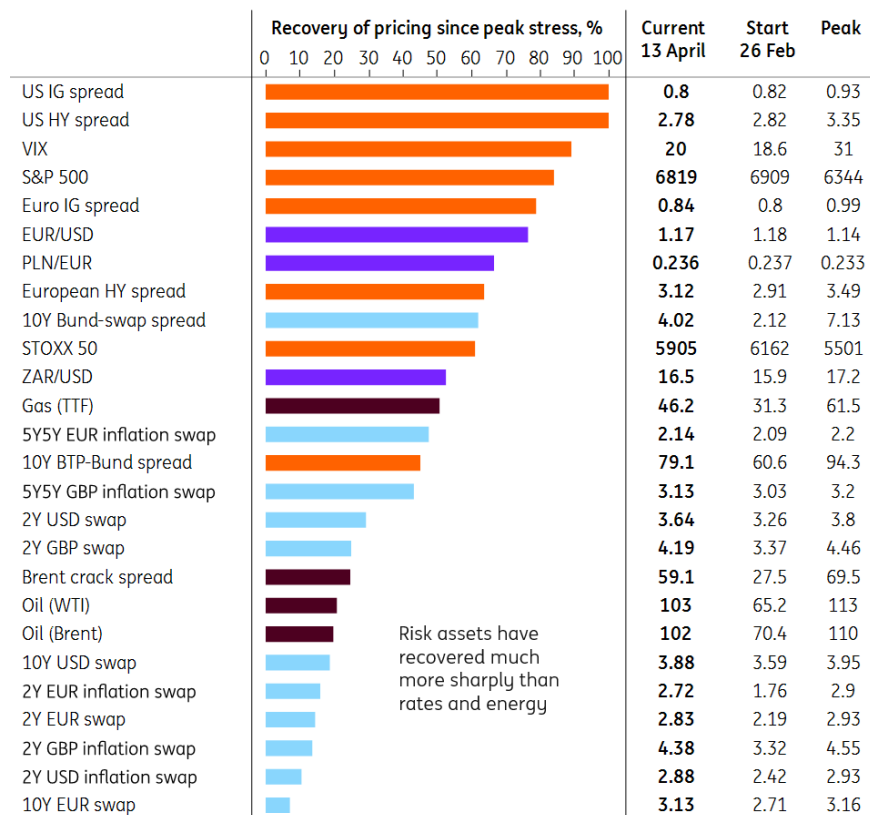
## Risk assets are choosing to downplay a major macro shock

Whilst headlines offer little reason for optimism, markets seem to take more of a wait-and-see approach rather than assuming what will happen. If anything, the glass is still half-full when looking at risk assets. We have looked at the performance of a wide range of asset classes since the start of the Middle East turmoil on 28 February, and equities are remarkably close to recovering to previous record levels. The S&P 500 has recovered around 80% of the losses and high yield spreads are practically back to normal. The 10Y Bund-swap spread, a measure of safe-haven flows, is also just 1bp away from February's pricing.

The strong performance of risk assets stands in contrast to the still-elevated oil prices and rates, which raises questions about the consistency in market pricing. The 2Y EUR swap rate at 2.7% is only just below the peak of 2.9% and well above the 1.8% at the end of February. Higher energy costs and monetary policy tightening should all else equal be a drag on growth and negative for equities and credit. Add on top higher discount rates and an increased uncertainty in terms of geopolitical risks. But markets seem willing to look through this.

The positive risk sentiment also means that global 10Y rates can still drift higher from here even if oil stays around current levels. Bonds, especially, are seen as a weak hedge against a further escalation of the Iran situation, favouring, eg, equities. So whilst we do think that growth should eventually be negatively impacted going forward, we won't push against the positive sentiment for now.

## In contrast to rates, US risk assets have almost fully recovered from the Iran turmoil



Source: ING, Macrobond

### Tuesday's events and market view

Despite growing optimism, markets will be sensitive to headlines surrounding Iran. While a ceasefire is technically in place, the situation remains sensitive to miscalculations.

However, with the notion sinking in that energy prices can remain elevated for longer, there will also be a focus on central bank speakers with a busy slate of officials taking the podium at the IMF spring meetings in Washington. From the ECB, Makhlouf, Lane, and later overnight Lagarde will be speaking. Speakers from the Fed are Miran, Goolsbee, Paulson, Collins, Barkin and Barr, while the BoE fields Greene and Bailey in surrounding events. The data front will be less relevant with the US NFIB small business optimism, the weekly ADP and March PPI the only notable releases.

Primary markets will come as a test of the recovering risk sentiment. The EU's syndicated sale of a new 20y benchmark alongside a 3y reopening announced yesterday had been anticipated, but France also announced the sale of a new 11y green bond. The UK will sell a new 10y gilt, also via syndication.

In terms of regular auction supply, the Netherlands and Germany will both sell 5y bonds, up to €3bn and €5bn, respectively.

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