

Rates Spark: EUR rates in transition mode

Higher US CPI today would be most damaging to short bonds, but the long end should do well regardless. EUR real rates are quickly moving to recession mode - lower volatility and greater risk appetite should eventually follow

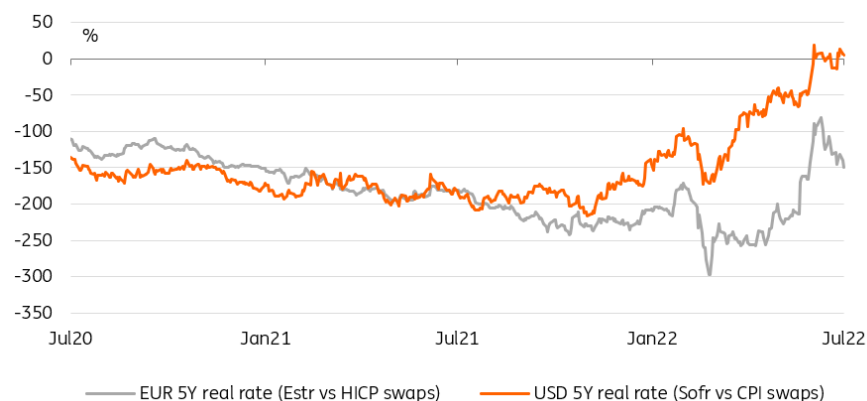


Dark clouds ahead as European markets are adjusting to a recessionary environment

Recession red lights flashing for the eurozone

Bonds are regaining their reputation as recession hedges. The US Treasury curve temporarily dipped below 3% during yesterday's session, except for the 30Y, although the long end looks set to follow suit if recession fears boil over. It is notable that this occurred as a) the US is no longer the epicentre of global growth fears (that title goes to Europe), and as b) the Treasury sells 10Y and 30Y debt into illiquid markets this week. With a Fed still hawkish in the face of inflation, and CPI set to accelerate today, these are prime conditions for the long end to outperform.

Falling EUR real rates show that a recession is the market's base case



Source: Refinitiv, ING

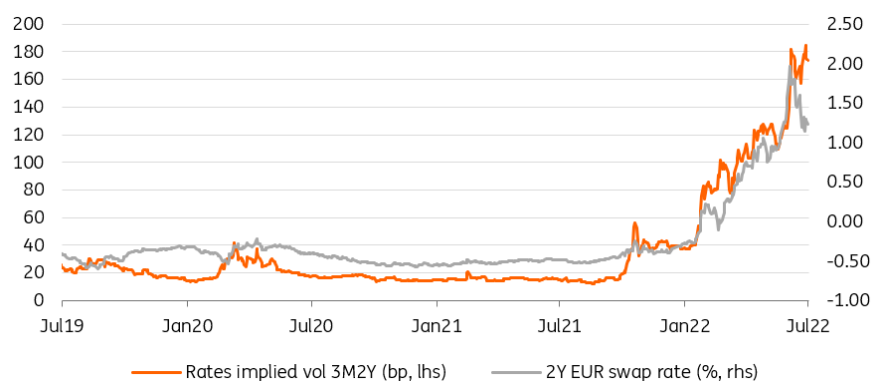
European markets are adjusting to a recessionary environment

The drop in US yields has been in keeping with the move lower in inflation swaps and, one might say, medium-term inflation expectations. In other words, US real yields are no longer rising, but they're not declining either. This contrasts with the eurozone where the recent rally has snapped the move higher in real rates. In plain English, EUR bond yields are falling faster than the inflation compensation of swaps, because European markets are adjusting to a recessionary environment. This isn't yet the case in the US, and today's inflation print should be a reminder of that.

More than halfway through the drop in rates, but volatility remains high

We're been talking so often about the disconnect between the number of European Central Bank (ECB) hikes priced by the EUR swap curve by mid-2023 (up to 300bp less than one month ago, now closer to 170bp) and our own (100bp) that this feels like a rant. And yet, markets are coming around to our view: the window for hiking rates at the ECB is closing fast. This certainly is an argument for hiking 50bp at next week's meeting, instead of the 25bp signalled by president Christine Lagarde, but this is beside the point. Front-end EUR rates are moving lower compared to unrealistic market pricing regardless of the size of the ECB hike.

Rates volatility has failed to follow EUR rates lower



Source: Refinitiv, ING

With rates moving lower at both ends of the curve, it might seem surprising that short-dated swaption-implied volatility prints new highs. As recession fears become more widespread, the uncertainty about the future path of interest rates should reduce. We're not there yet but there is a tendency for volatility to slow when rates get closer to the lower bound, wherever it may be.

Tamer rates volatility should eventually translate into better risk appetite in other markets

This is not to say that the risk of sticky inflation has disappeared, but we think the current mix of lower rates and higher volatility is incompatible in the longer run. Perhaps it is explained by likely worsening liquidity over the summer months but, if we're right in expecting trading conditions to improve by the end of the summer, volatility should follow rates down and make the current valuations more justifiable. By that point, it might be too late to chase sovereign yields lower, but tamer rates volatility should eventually translate into better risk appetite in other markets.

Today's events and market view

Today's eurozone CPI prints are final readings. In normal times, these tend to come in line with previous estimates but greater volatility and uncertainty in inflation dynamics means revisions are possible. This will be followed by May eurozone industrial production.

Italy kicks off today's euro sovereign supply with auctions in the 3Y, 7Y, and 15Y sectors. Germany will then sell €1.5bn 30Y debt.

The real fireworks will have to wait for the US session however, with the June CPI print being easily the most awaited economic release this week, and perhaps this month. Headline inflation is expected to accelerate but core should slow. Bonds have rallied into the release making up for a potentially damaging set up in case of an upside surprise. Given the current recessionary environment, we doubt a jump in yields would be sustained except at the very front-end of the curve.

The US Treasury will auction \$19bn of 30Y bonds which might translate into greater volatility at the long end but we're expecting long-dated bonds to perform better, especially in case of higher-than-expected inflation.

Authors

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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