Rates Spark: Eye of the storm

Market inflation measures are creeping up again and today's data will ensure that the topic stays in the headlines. Volatility is also inching higher as markets will have to cope with a fundamental sense of uncertainty for longer. Next week could allow for a breather – fewer data, modest supply – although this may support the ongoing ASW widening dynamic.

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The inflation scare and tightening fears aren't going away anytime soon

With the US out on a holiday it was a less eventful session yesterday. That does not change the fact that the current worries aren't going away anytime soon. If anything, inflation swaps have continued to creep up again and also volatility measures are inching higher.

In the Eurozone the belly of the curve underperformed as the ECB's Holzmann suggested that the asset purchase programme could end September next year. While this was the voice of a known hawk, it can help refocus the discussion also in the market on the issue at hand, i.e. the tapering of purchases before any hikes are considered.

It is interesting to note that yesterday's price action was concentrated in swaps rather than bonds. There is reason to believe that asset-swap spread (ASW) will continue to behave more
directional with the development of rate hike expectations. Bonds could prove relatively more stable amid the ongoing collateral squeeze going into year-end while the volatility plays out to a larger degree in swaps. It is then no coincidence that we have witnessed a widening of especially shorter dated EUR ASWs. Mind you, the current squeeze after the ECB’s exceptional buying spree since the pandemic is in no way limited to German bonds this time around. The 2Y ASW of French bonds is at its widest since end 2016.

The story is likely more nuanced in Gilts which saw the largest move yesterday. An element of flight to safety as Brexit is making the headlines again cannot be dismissed. But keep in mind that also here the more general widening in ASWs has been underpinned by the UK treasury substantially reducing its Gilt issuance outlook.

Rates implied volatility on the rise will also bring higher yields

![Graph showing rates implied volatility on the rise](source: Refinitiv, ING)

Hopes are for a less vicious upcoming week

The upcoming week may provide a chance for markets to settle down somewhat after eventful weeks. Apart from perhaps the US retail sales and in the UK the CPI report there are no bigger data releases or central bank meetings prone to rattle markets as viciously as over the past few weeks.

For sure, central bank speakers will be heard again – there is a long list of Fed speakers already scheduled and we will also hear from the BoE’s Chief Economist Pill – and on the more global scale Chinese activity data starting into the week and headlines such as those around gas supply threats by Belarus amid rising tensions in the region could still set the tone.

There is a bit of supply that needs to be digested, the US Treasury will sell a 20Y bond, certainly more closely followed after the weaker 30Y sale this week. But in the Eurozone there is only a smaller 30Y Bund tap and Finnish auctions to account for in core markets. The scheduled French auctions are in shorter dated bonds plus linkers while Spain will be active in the periphery. This supply backdrop could prove supportive for the ASW widening dynamic.
ECB hike expectations should widen swap spreads further

Today's events and market news

Markets may stay calmer than usual with many in the US likely to take a day off between yesterday’s holiday and the weekend. Nonetheless, data will make sure that inflation will stay in the headlines. After the surprisingly high US CPI release markets will pore over the University of Michigan Consumer sentiment data, in particular the inflation expectations to sense any potential de-anchoring thereof.

The notable release in the Eurozone is the September industrial production data, which is expected to post a ~0.5% month on month amid ongoing supply constraints. ECB’s Lane will speak at an EU Commission event on the future of fiscal governance frameworks.

No supply is scheduled for today, but France and Spain will announce next week’s auction menus.

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