Rates Spark: Flight to safety

Government bonds still fulfil their role as a safe haven as geopolitical events unfold in the Middle East. Bunds rallied sharply, and US markets will still have to catch up. Higher oil prices create headaches for central bankers, but for markets, the drag on growth seems to outweigh this time

Bund rally in a flight to safety...

Even after the staggering sell-off over the past weeks, Bunds have not lost their appeal as a safe haven. Flight to quality marked yesterday's session as the events in the Middle East unfolded. One result was that the yield on the 10Y Bund dropped by more than 11bp versus Friday's close. But front-end valuations also rallied, with 2Y Schatz yield 9bp lower.

The front-end rally is interesting in so far as it also faced the headwinds from oil prices having risen by 4%. While energy prices seemed to stabilise at these higher levels, we saw shorter-dated inflation swaps such as the 2Y surge by 14bp. Longer inflation expectations appeared less impacted with 5y5y ending little changed at 2.5%. But the upshot is that we saw an even larger drop in shorter real yields, with 2Y real ESTR OIS dropping 20bp.

Despite the European Central Bank (ECB) pointing at higher oil prices as a potential stumbling block towards reaching its inflation goals – as Vice President Luis de Guindos did again yesterday – the risk-off tone and the drag on growth from higher energy prices amid greater uncertainty appears to outweigh in front end pricing. The probability of another ECB hike is seen at close to zero, and the date of a first fully discounted rate cut was pulled ahead to June next year.

Notably, part of the rally yield rally was also being attributed to more dovish comments from the Federal Reserve's Lorie Logan, who suggested that the Fed may see less need to raise rates further after the rise in yields as a higher term premium could do some of the work in cooling the economy.

...and sovereign spreads widen, leaving Italy in the spotlight

Sovereign spreads over Bunds widened with Italian bonds still performing the worst, but not alone in the general widening. The key 10Y spread for Italy widened 4bp by the end of the day, but Spain was not far behind widening 3bp. This points more to the general risk-off notion than the Italy-focused widening we had witnessed before.

But spread levels for 10Y Italy above 200bp have ECB officials taking a closer look and cooling on the idea of ending PEPP reinvestments early. A Reuters story cited officials suggesting that the widening was justified so far as it was a fair reaction to the government's fiscal policies, and most thought current levels would not warrant making use of PEPP reinvestments yet. Only one thought a discussion about TPI when levels were to reach 250bp would be more appropriate.

Overall, the source's story suggests some reluctance by the ECB to actively step in and in turn more widening potential for the spread on the back of lingering fiscal concerns. We would add that if the nature of a further widening were to change, i.e., driven more by a general risk-off sentiment, then this may lead to a rethink on deploying the first line of defence.

Today's events and market view

Geopolitical events have pushed investors back into safe havens, turning around the sell-off in government bonds. While the 10Y UST yield already dropped 16bp in Asian trading overnight, US markets will fully return from their holiday later today and will have to catch up with the events. There is little clarity yet on how the situation will unfold, and rising energy prices are creating further headaches for central bankers who aim to wrestle down inflation in a timely manner. At the same time, conflict in the Middle East is another entry to an already long list of risks to economies which have already been weathering tighter conditions.

There is little on the data calendar today aside from the NFIB small business survey in the US and a few central bank speakers. Overall, that could mean that headlines dictate direction. We do have supply activity, with the EU having mandated a new 20Y bond alongside a 3Y tap, likely today's business. Portugal conducts an exchange transaction and Germany will tap inflation-linked bonds while the US sells a new 3Y note.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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