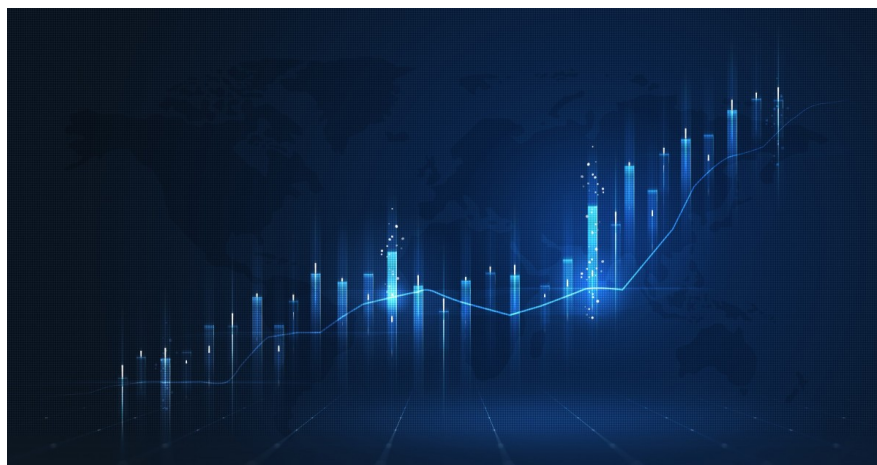


Rates Spark: Hawkish rates alongside higher inflation expectations

The US has seen a 1% rise in the 2yr inflation breakeven, and disinversion. Higher market rates makes full sense. Stronger-than-expected sentiment indicators have sent bond yields to new highs, and tonight's Federal Open Market Committee minutes aren't likely to change that. Broader market sentiment is souring as the reality of higher rates hits home



The rise in US market rates coincides with a remarkable 1% rise in the 2yr breakeven

We frequently noted in recent months how remarkably low the US 2yr breakeven inflation was. It got down to the 2% area in September last year, and was there again in mid-January this year. Remember, a 2% breakeven means inflation would have to get below that, well below, in order to average 2% over a two-year period. But that's where we were. Well no more, as we are now at 3%. That's a whole different picture for inflation in the coming quarters.

So, there has been a remarkable 1% rise in the 2yr breakeven in a matter of four weeks. And there has been no material fall in the 2yr real yield, which remains in the 1.85% area. It fits with the market moves of the past few weeks, which has seen the 10yr move up from 3.4% to now over 3.9%. We had expected something like this, as the curve was far too inverted, and the back end was prematurely discounting interest rate cuts.

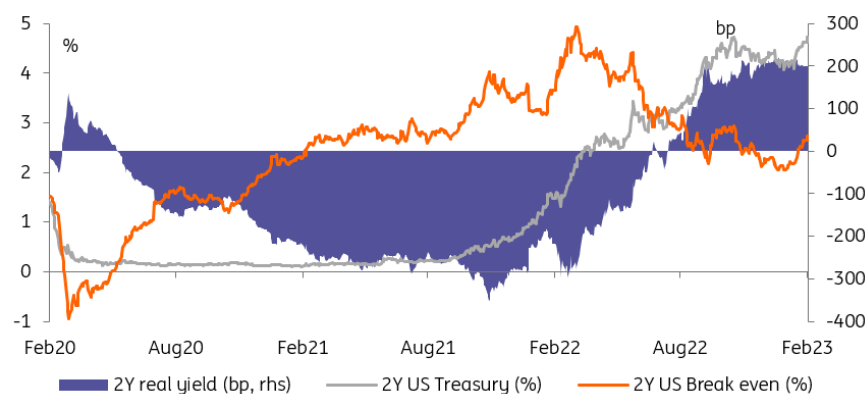
The back end is being far more reactive to the front-end fears that the Fed is not done till they are actually done

In this respect we had been watching the spread from 6mth Libor to the 10yr Treasury yield. That got down to an extreme of 1.8%. That spread which had the 10yr Treasury yield at 1.8% through the 6mth rate had never been as stretched as that before in modern times. Something had to give, and we called for 10yr yields to rise. They have, and the spread is now into 1.4%. It's still elevated, but now the back end is being far more reactive to the front-end fears that the Fed is not done till they are actually done.

We are likely to see some buying into the market on the approach of 4% on the 10yr. Asset managers will look at a 4% handle as a good level. And liability managers will use these elevated 5-10yr fixed rates to do some swapping to floating for long term positive cumulative carry. That should help to mute any big break above 4%. The market is not in a mood to do so though, and we'd likely need to see some stability before the flows really come in.

As we noted some weeks back, a popular theme in this environment has been for be long the ultra front end; in money market funds earnings a rolling 4% to 5% on zero risk, and we noted flows into this space. That's been a good idea so far, but can be balanced up now by morphing some flows into longer duration product, while still holding a chunk of front end risk free exposure. Our recent piece going into all of these factors are to be found [here](#) and [here](#).

The rise in 2Y nominal yields is matched by higher inflation expectations



PMIs are upbeat but market sentiment is souring

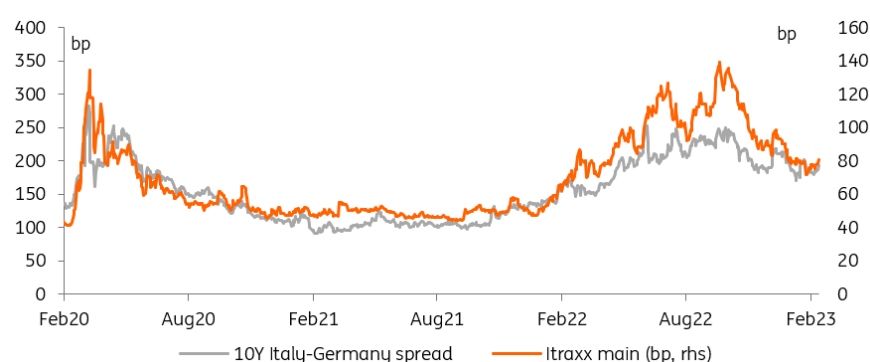
Markets are dusting off the 2022 'sell everything' playbook as government bonds are printing new highs for the year, and cracks are starting to appear in risk assets. The direction of travel for rates is easier to understand. Better-than-expected PMIs across Europe and the US added to the impression that the loss of economic momentum expected at the end of 2022 is proving much more benign than foreseen at the time. Note that PMIs are still flirting with the 50 level indicating anaemic expansion, but this was enough to provide a further boost to central bank tightening

expectations, especially with wage pressure and higher selling prices being highlighted for the service sector.

Markets are dusting off the 2022 'sell everything' playbook

Nowhere was the surprise as clear as in UK PMIs. After months of doom and gloom, the survey painted an upbeat picture, and cast a long shadow on hopes that the Bank of England's hiking cycle is coming to an end. Our expectation is that one more 25bp hike will be delivered at the March meeting. The market is now pricing two full hikes in March and May, and a 50% chance of a third one in June. Our economics team has argued that inflation (softer than expected in the last report) and employment (stronger) are more important in dictating the next policy steps but, in any case, there will be one more release of each before the next BoE meeting.

Higher core rates are starting to impact higher beta fixed income



Source: Refinitiv, ING

Markets set to look past less hawkish FOMC minutes

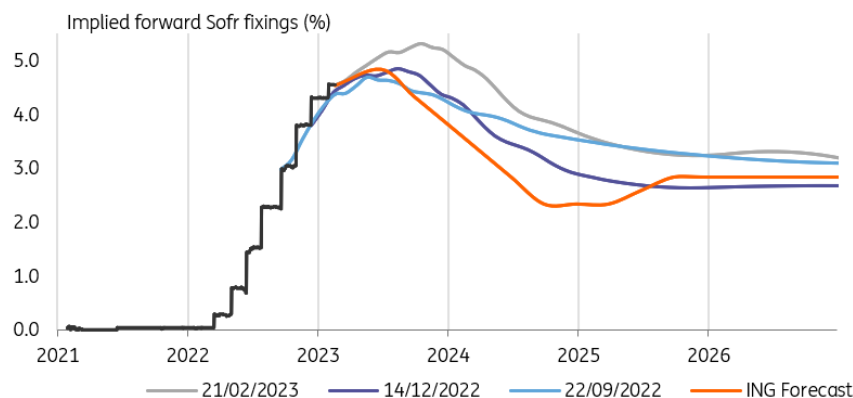
Treasuries are going into tonight's release of the February FOMC minutes at their highest yield level this year... and after touching their lowest level the day after that same meeting. In other words, information processed by the market since the February FOMC meeting triggered over 50bp repricing higher in 10Y yields (for the 2Y it's closer to 60bp). In this light it is fair to say that the minutes are not just three weeks old, they're also 50bp old.

We struggle to see markets coming around to that disinflationary view

We view the risks around this release as balanced. On the one hand, some subsequent Fed comments suggested that a couple of members may have made the case for a 50bp hike, instead of the 25bp it delivered. On the other hand, Powell's less hawkish tone than in previous meetings may well be a reflection of the broader mood on the committee. The repeated focus on

disinflation, in particular, was taken as a cue by the market that the Fed thinks it has made sufficient progress on its fight against inflation to stop hikes soon. We struggle to see markets coming around to that disinflationary view even if it was expressed that clearly in the minutes. The curve is now pricing three more 25bp hike, which implies the hiking cycle ending in June.

USD rates are going into the February FOMC minutes with much more hawkish expectations



Today's events and market view

The delayed January inflation report for Germany published this morning saw no upward revision to the provisional number published earlier this month, but it showed core inflation accelerating from 5.2% annualised in December to 5.6% in January.

The better-than-expected PMIs across Europe in February should also be reflected in Germany's Ifo published today despite a lacklustre reading in Germany's manufacturing PMI. In any case, we think the bar is high to douse the increasingly hawkish pricing in euro rates.

In bond supply, Italy is due to sell inflation-linked as well as 2Y bonds. Germany will also add to this with a 10Y auction.

The US data calendar is pretty light but the Fed will release the minutes of the February FOMC meeting.

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