Rates Spark: In search of that curve-steepening optimism

At this stage of the cycle, curve steepening tends to occur when short rates drop. This makes last week's bear-steepening all the more noticeable. We think the economic optimism required for long-end rates to catch up to the front-end is missing. Today's Zew should confirm that

Curve steepening in a hiking cycle is typically caused by falling front-end rates

There was a pretty noticeable turnaround of the curve-flattening theme last week. Flattening has dominated interest rate markets since it became evident that central banks needed to tighten policy to fight the inflation surge. This is not the first time the curve has re-steepened in this cycle. The last such steepening, in March this year, as investors fretted about the risk of a banking crisis in the US, was caused by a reassessment of the near-term path for policy. In other words, it was caused by a plunge in short-term yields. Previous occurrences in this tightening cycle fit that mould and, each time, the move has been promptly reversed.

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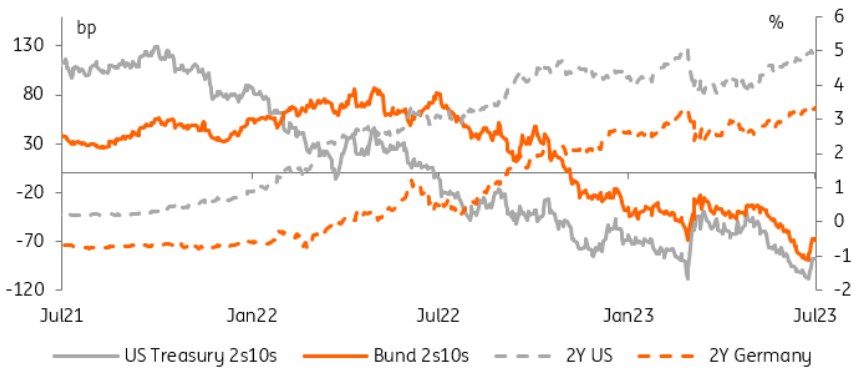
Last week's curve steepening differs in that it was largely driven by higher long-end yields. If the move extends, it will be a departure from the trend in place since early 2021 in the US and early 2022 in the eurozone. This would be more than a mere technicality. What rates specialists call a bear-steepening of the curve, put more simply is a rise in long-end yields. For instance, for the 2s10s US Treasury curve to bear-steepen back to flat, from over 100bp inverted at the start of the month, the 10Y would need to rise to almost 5%, from just above 4% currently. This would be a significant improvement in the transmission of tighter monetary policy which has struggled to propagate fully to longer-dated forms of borrowing, and a sure drag on the economy.

Unlike previous steepening episodes, last week's wasn't caused by a fall in front-end rates



Source: Refinitiv, ING

An unlikely vote of confidence on the economy and central banks' stewardship

Curve inversion is a very natural phenomenon when the front end rises. It reflects the fact that the market collectively forecasts rates to subsequently fall back towards their long-term average. There are a lot of assumptions in this reasoning. One is what is the correct long-term level for rates, another one is how long it takes for them to drop back to, or below, this level. For the curve to steepen near the peak of a hiking cycle, which we think will be reached in July and September for the US and eurozone respectively, markets need to assume that no cut will follow, or indeed that there could be more hikes down the line. This, in other words, is a massive vote of confidence in both the economy's strength, and on central banks' ability to find exactly the right level of rates that slows inflation but not the economy, assuming such a thing exists.

The risk of a protracted fight against inflation is real, but we doubt this is what has steepened yield curves since the start of the month

The recent resilience of the US economy makes this narrative slightly less unlikely than thought earlier this year, but it remains a stretch. More likely, by pushing the expected start date of the Fed's cutting cycle further out in time, it makes bets on falling long-end rates less attractive for investors with a shorter investing horizon, especially into this week's long-end US Treasury auctions.

Today's Zew survey should, if consensus is any guide, confirm that no such optimism exists in Europe. To us, the risk of a protracted fight against inflation is real, but we doubt this is what has steepened yield curves since the start of the month. More likely, lower rates bets are losing in popularity and the very inverted yield curve levels a week ago made a snap back more likely. We reserve our judgement on a more macro-related bear-steepening, but we're sceptical that the necessary optimism exists.

Today's events and market view

The main economic releases of note this morning are Italy's industrial production and Germany's Zew sentiment survey. Regarding the latter, both the current conditions and expectations components are forecast to decline, in line with the general gloom in the eurozone, if Bloomberg consensus is any guide. The National Federation of Independent Business small business optimism in the US completes the list.

There will be plenty of 7Y core bonds on offer, with the Netherlands and Germany both issuing today. Greece has also mandated banks for the launch of a 15Y benchmark via syndication. This will coincide with a tender offer for 2Y and 3Y bonds.

In the US, the treasury will begin this week's supply slate with a 3Y T-note auction.

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