Rates Spark: Inflation reasserts itself as the main driver of rates

Inflation worries still loom large in the market's psyche, even with rising growth concerns. Risk sentiment doesn't fare well in these circumstances. Sterling markets seem like a haven of relative calm, as we believe the BoE will hike twice more this year but pause after the summer. Gilts are already waking up to the less hawkish reality

Markets are nervous about inflation

Bonds are still scared of the inflation bogeyman

The post-German CPI rout in the euro bonds has been a reminder of a number of important points about markets currently:

- Sensitivity to inflation remains high, even if global growth concerns are rising. It was interesting to see markets putting more emphasis on a CPI beat (in Germany) than on a GDP miss (in the US).
- Risk assets seems to suffer on both inflation and growth concerns. None of these (non-mutually exclusive) outcomes seems particularly helpful for risk appetite.
- Europe is increasingly at the epicentre of large interest rate moves. In our view this is due to greater concerns for its growth, and due to a central bank that is perceived (rightly or

wrongly) to be less likely to act aggressively.

Risk assets aren't faring well either on growth or inflation worries

Source: Refinitiv, ING

With this in mind, the risk of double-digit German inflation prints in the coming months, flagged by our economics team, promises to keep rates volatility elevated. Even if growth slows down, it will be difficult for market participants to justify greater exposure to interest rates markets, and so trading conditions risk being impaired for at least a few more months.

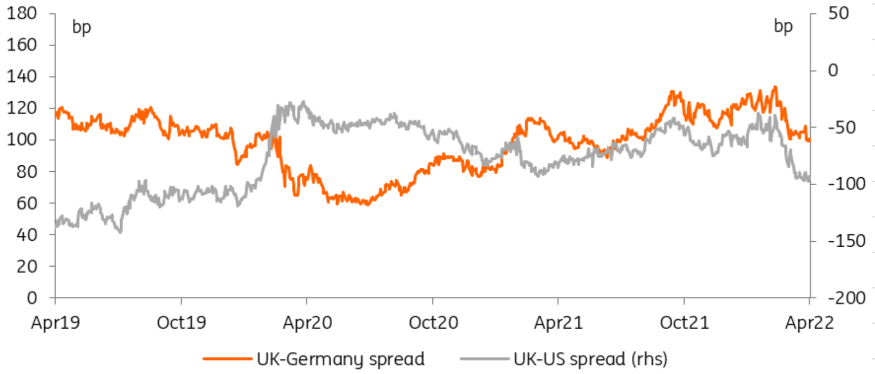
Late cycle dynamics on the sterling rate market

Interestingly, it is markets where the local central banks have acted early that are displaying some degree of calm. It would be a mistake to extrapolate a few weeks of price action but interest rates markets seem to support the view that a short and sharp tightening cycle is preferable to a more protracted approach, even if its aim is to preserve growth.

> *We expect hikes discount to continue deflating as the year progresses*

The Bank of England (BoE) is a case in point. To be fair, the reluctance in rates markets to price an even more hawkish path has as much to do with worrying confidence indicators, as it has to do with the BoE being ahead of the curve compared to its continental counterpart. Still, we think the Bank Rate will be hiked twice before the summer, at the May and June meetings, followed by a pause. This is a more dovish path than what the curve is priced for and we expect hike discount to continue deflating as the year progresses.

Gilts are tightening to Treasuries and Bunds as the outlook worsens



Source: Refinitiv, ING

The gilt market is already waking to the possibility, with spreads to both US Treasuries and German Bunds tightening since their early March peak. We expect sterling rates to display more reluctance than their euro and dollar peers to cross psychological barriers, although 10Y gilts crossing 2% cannot be excluded if its US and German peers also rise above 3% and 1% respectively.

Today's events and market view

This week's round of Eurozone inflation data concludes with French, Italian, and Eurozone CPIs. The upside surprise to Germany's index has likely skewed expectations higher, but the release has shown that markets are still very sensitive to upside surprises. Despite renewed volatility in energy markets, the focus should increasingly be on core measures to assess how much the energy-related jump is feeding into other components.

Slightly less market-moving but relevant nonetheless due to worries about Europe's growth outlook, Spanish, Italian, German, and Eurozone 1Q GDP will also be closely watched.

Economic excitement will not be contained to Europe, however. Chicago PMI, personal income and spending, and a final reading of the University of Michigan consumer confidence index make up the US release list for the day.

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