Article | 2 March 2023

Rates Spark: Inflation breakevens continue to add pressure

The rise in short tenor inflation breakevens (1-3yr) in the past few weeks has been nothing short of spectacular, up by around 1%. They may be at more sensible levels now, but the key takeaway is a severe dent to market confidence for big and quick falls in inflation ahead. This also pressures long rates higher, in tandem with rises in official terminal rates

The remarkable rise in short tenor inflation breakevens continues

US 2yr breakeven inflation is now at over 3.3%. It was at 2%, just over a month ago. We remarked at the time that a 2% breakeven was far too low, as to get there inflation would have to smash below 2% for a period (so that it could average at 2%). In a way the current discount at 3.3% is a more sensible one. But either way the move from 2% to 3.3% for 2yr breakeven inflation is a remarkable one, and paints a clear picture of a knock to market conviction that inflation can collapse lower in the next couple of quarters.

Inflation breakevens are up 1.3% on front-end US and 90bp on front-end eurozone

In the eurozone, front-end inflation expectations never got as low as they did in the US. But there too there has been a drift higher in breakevens. The French domestic breakeven rate has risen from 3% to 3.6% in the past couple of weeks. And the European measure has risen from 3.1% to almost 4% on the 1yr breakeven, and from 2% to 3.1% on the 3yr breakeven. These are material rises in short term inflation expectations, correlating with upside swings to terminal rate expectations, and translating to upward pressure on long-term rates to boot.

That pressures long tenors rates up to. And they should be much higher in fact...

Long-term rates (e.g. the 10yr) are heavily influenced by terminal official rates. Typically there would be a term premium added on to the terminal rate to help derive the 10yr rate. But here there is no premium, there's a discount. And that discount shows up in a remarkable inversion on curves. It's most pronounced on the US curve, but also building on the eurozone one. It also builds on the notion that hikes will be followed by cuts. But even factoring that in, the inversion is stark.

Longer tenor rates really should be higher, but inversion pressure is taming things

History suggests that the US 10yr should in fact be getting to a 5% handle, if the funds rate is set to peak at close to 5.5%. The 10yr likely won't get there as there is a strong likelihood that risk assets eventually crumble and credit spreads re-widen, which puts a bid back into core bonds. In that respect a re-visit of the prior highs at 4.25% is achievable, while 5% is logical but likely to be frustrated by risk outflows.

That is provided the market does not drift up to a 6% terminal funds rate discount. We doubt that will happen, but the terminal rate discount in the US is up 50bp in just a few weeks already. We think what happens to risk appetite is key ahead. A calming sould calm rates. If not, talk on 5% and 6% handles will continue to circulate.

It's been quite a week, and it concludes ahead with PMI readings out of the eurozone and ISMs out of the US. Remarkably these are holding up in the 50's and above (just about), signaling a moderate expansion. Given the extent of rate hikes delivered to date, these should really have seen more downward pressure. At the same time, they have in fact seen a turn-of-the year pop off lower levels seen late last year. Watch the US ISM employment and prices paid readings in particular. If these cling to strength then the pressure remains for market rates to be pressured higher. We still think this will be temporary though, as higher rates should bite more in the months ahead.

Authors

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

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

Disclaimer