

Rates Spark: Yields are looking up again

Headlines on the debt ceiling give rise to cautious optimism. Central bankers' consistent message is looking more credible and hikes are being considered again, bear-flattening yield curves. For now, all are within recent ranges



US House Speaker McCarthy expressing confidence that there won't be a default

Curves re-flatten on returning optimism

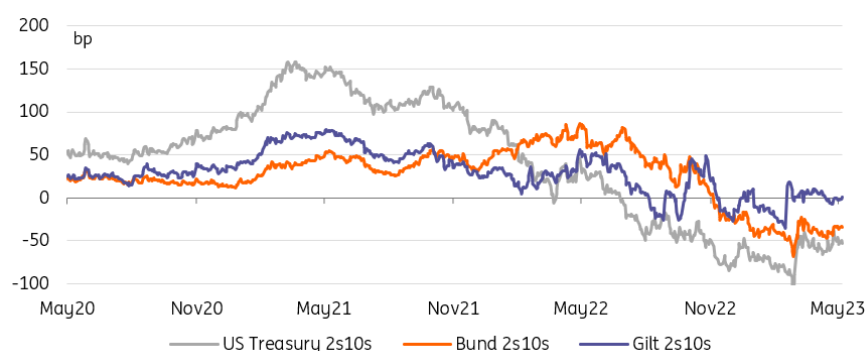
The cautious optimism returning to the market is allowing a refocus on the relatively consistent message that has come from central banks in recent weeks. In the US the 2Y Treasury yield was pushed higher, by 7bp yesterday as markets priced out some of the tail risks surrounding the outlook. The near-term discount of the Fed policy has realigned a bit more with the Fed's, on balance, still hawkish tones. Markets are now seeing a probability of around 20% again for a hike in June while the total amount of rate cuts seen by year-end was scaled back to less than 60bp. Not too long ago markets were looking at around 80bp, close but still below our own forecast of 100bp.

Debt ceiling negotiations can be volatile, but banking tensions look set to simmer on

It was not data releases that triggered this latest bear flattening of curves. It was combination positive headlines surrounding the two risk factors most closely monitored by markets. Reports of deposits growth at some US regional banks eased some of the fears around the simmering banking tensions. But the main driver appears to have been the more optimistic tones surrounding the ongoing debt ceiling negotiations, where House Speaker McCarthy expressed confidence that there won't be a default.

Yesterday may have given us a foretaste of what could be in store should there be a quick resolution of the debt ceiling, but we also are wary of too much optimism, especially with regards to the effects of the banking tensions. The developments suggest some stabilisation and maybe lower tail risks of further default events, but there remain many other uncertainties such as exposures to commercial real estate to give rise to caution. The tightening of lending standards is not suddenly turning. Debt ceiling negotiations can be volatile, but banking tensions look set to simmer on.

2s10s curves bear flatten, but all are still within recent ranges



Source: Refinitiv, ING

Risk sentiment nudges up ECB pricing and narrows spreads, but not all

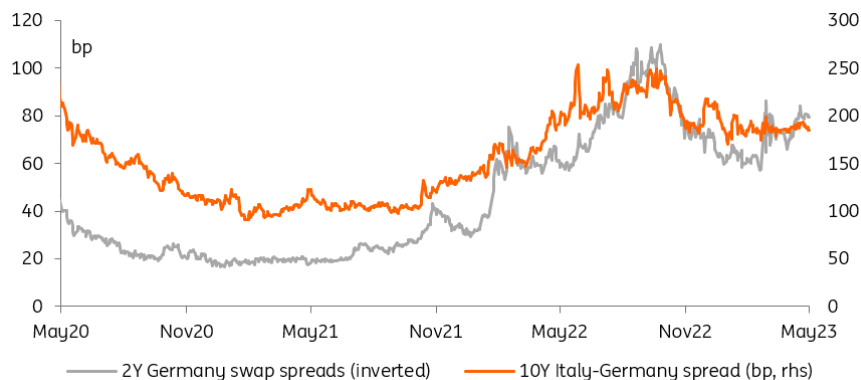
The return of optimism also spilled over into EUR markets. In fact, the curve flattening was even more pronounced than in the US with the 2-10Y Bund curve flattening by more than 6bp on the day. At the front end money markets are now fully discounting two 25bp hikes by September. Optimism is also evident in the space of sovereign spreads where the benchmark 10Y spread of Italian government bonds versus Bunds has tightened to below 185bp to reach the narrowest levels in a month.

Bund ASW are defying the optimism

The only space where we not seeing the improved risk sentiment being reflected is Bund ASW levels. In particular the 2y Bund ASW shows little inclination of budging form the current 80bp area. While traditionally a risk measure, the wide spreads are currently more a reflection of returning collateral scarcity concerns after the European Central Bank has made the remuneration of government deposits on its balance sheet less attractive since early May. Since then some

€115bn of government cash previously parked at the ECB has pushed back into the market.

Bund ASWs defy the returning optimism reflected in other sovereign spreads



Source: Refinitiv, ING

Today's events and market views

We are approaching the upper end of recent yield ranges with the 10Y UST yield marking a high above 3.58% yesterday. Curve-wise the 2-10y spread is close to -60bp and thus the lower end of the range since the Silicon Valley Bank debacle. We would not exclude that more positive headlines can see these thresholds being breached, but our hunch is that it would take more conviction to erase the impact of the banking turmoil on rates. Here data, in particular on inflation, should be more decisive. But markets will have to follow the slow beat of economic releases.

For today we expect a more quiet European session with many countries observing a public holiday. We will still be seeing auctions from Spain and a slate of ECB speakers including Vice President de Guindos and Estonia's Muller.

Data highlights come out of the US where a particular focus should be on the initial jobless claims after their recent softness. Other releases cover existing home sales and the Philadelphia Fed regional index. Later in the day attention will turn to the weekly data on money market fund flows and the Fed release on its emergency lending to banks.

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