

Rates Spark: Low on energy

Bond yields continue their plunge on hopes that falling energy prices will help in the fight against inflation. The strength in the US labour market may not last but it is preventing Treasuries from joining the party. The Fed has also reiterated its unfinished rate hike work through the latest minutes. The next big cue comes from Friday's payrolls report.



Fed insists on higher for longer in their latest minutes

Market reaction to the FOMC minutes was muted. Breakevens, real rates and nominal rates did not do much at all. Although at the margin there has been a tendency for rates to test a tad higher, especially on the front end. The Fed has given a clear bias to continue to hike rates in the months ahead, so that makes a degree of sense. Further out the curve, the market is not paying too much attention, mostly as there is not a whole lot new from the minutes.

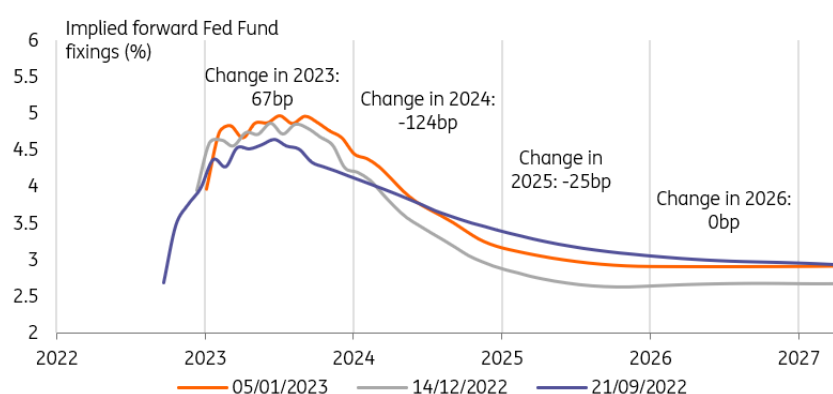
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On the technical front, the Fed noted the ease lower in use of the reverse repo facility, and noted

that this went hand-in-hand with upward pressure on market repo. The Fed also notes an expectation for this to continue in the months ahead, in tandem with the ongoing bond roll-off from their balance sheet. The Fed also notes that this reflected the move of money market funds away from the reverse repo facility and towards market repo.

Our observation here is that this has been quite minor so far. SOFR is struggling to make it much above the reverse repo rate (at 5bp over the fed funds floor, now at 4.30%). But it should gather more pace as we progress further through 2023. As SOFR eases above the Fed's reverse repo rate in a more material fashion in the months ahead, there should be a larger reduction in cash going back to the Fed on their reverse repo facility.

Rates shrugged off hawkish Fed minutes to continue to bet heavily on 2024 cuts



Source: Refinitiv, ING

The fall in energy prices triggers another 'everything rally'

Bund yields are down almost 30bp since the start of the year, which is to say they've dropped almost 30bp in three days. As we discussed in yesterday's Spark, we think the (mostly energy-related) drop in inflation in December is a red herring. Whilst helpful at the margin, we think core inflation should be a better predictor of European Central Bank policy. This drop in yields has been as sudden and relentless as the rise into year-end. Swaption implied volatility is down since its September peak but there are no signs so far that 2023 will prove a calmer year.

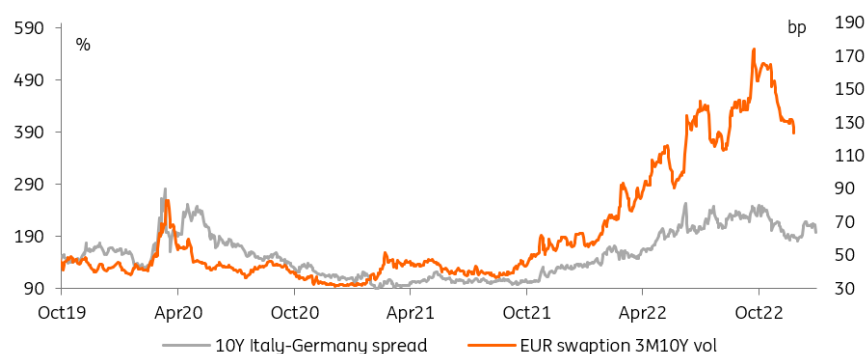
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Of course, anyone in search for a cause to explain the bond rally should look farther than backward-looking inflation indicators. The fall in yields has come alongside a collapse in energy prices. That trend is nothing new, explained in Europe by milder weather than normal and in the wider world by fear of a growth slowdown, in particular in China, but also reinforced by a weak ISM manufacturing in the US. This has resulted in another case of 'everything rally' where both stocks and safer bonds benefit from hopes that central banks will have an easier job tackling inflation.

Students of the late 2022 playbook know that the 'everything rally' comes with tighter peripheral

spreads. The 10Y Italy-Germany spread for instance has retraced almost half of its 36bp post-December ECB meeting widening.

Implied volatility is down as peripheral bonds outperform



US labour market strength is tough for Treasuries

One area of persistent strength has been US labour market indicators. The ISM employment sub-index rose back above the 50 level, a development that [our US economist thinks is hardly sustainable](#) in light of the fall in other components. Together with higher-than-expected job openings, they offer little relief to a Fed concerned about wages feeding into core services inflation, as Fed Chair Jerome Powell is fond of repeating. If current inflation is a guide of how much further the Fed has to hike, recent data points to an imminent end to this hiking cycle. But if the job market is a guide of how long it would take before it decides to cut rates, there is still a protracted period of restrictive monetary policy ahead.

A re-steepening of the US curve is on the cards

At face value, this means a re-steepening of the US curve is on the cards. And indeed, the US curve has shown signs of re-steepening from very inverted levels. Our own view is that both growth and inflation will soften enough to allow the Fed to loosen policy in the latter half of 2023. Much of the action in recent days, however, has been driven by the duration rally. This means that longer bonds outperformed and the curve flattened. This isn't necessarily consistent with the data but it seems markets are comfortable with the longer maturity skew in supply, starting today with long-end auctions and syndications from Europe (see events section below).

Today's events and market view

Portugal and Ireland mandated banks for the launch of new benchmarks which we expect today. Both deals are at the long end, respectively 15Y and 20Y. This will be the second green bond on the Irish curve. They will add to scheduled long-end auction from France, with maturities of 9-43Y.

The drip-feed of eurozone inflation data continues today with December CPI from Italy, and PPI for the whole of the eurozone.

The US data slate comprises Challenger job cuts, ADP employment, jobless claims, and services PMIs.

We think the strength in US labour market indicators and heavy long-end supply will dent the performance of bonds, a bear steepening of yield curves appears most likely into the end of the week.

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