

Rates Spark: Markets are doing central bankers' job

Tightening financial conditions could mean markets see less of a need to hike rates. It is still early days and previous signs of worsening economic outlooks were met with a shrug by rates markets. Supply is also clouding the picture, but further curve bull-steepening would be a significant macro signal



Rising US real rates and falling US inflation expectations

The price action of late has been remarkable. The big upside test seen for US yields has been driven overwhelmingly by rises in real rates, and that pressure remains. At the same time the big fall in US market rates late yesterday was driven by a fall in US inflation expectations. The latter bit will please the Fed. They delivered 50bp, and the promise to deliver another 100bp in the next couple of months, while chunky, is still below where the market discount had been. The risk the Fed ran was that inflation expectations could have spiked. That has not happened. In fact inflation expectations have eased. Instead it's real market rates that have risen.

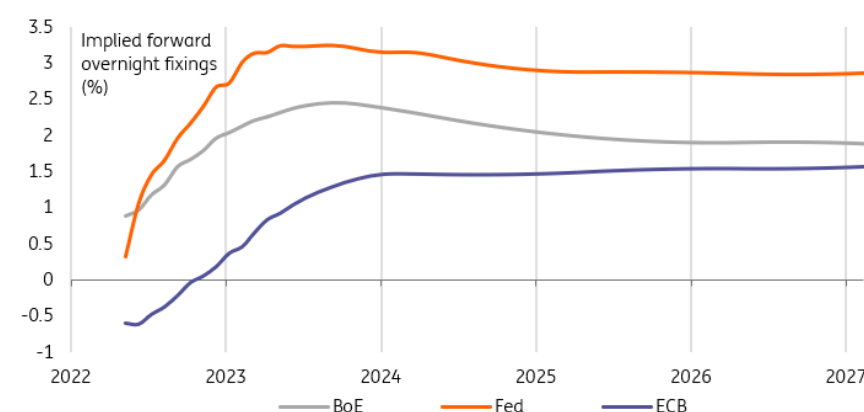
The thing is this can go unchecked, as the Fed will not step in to prevent a rise in real rates, as such rises are in fact doing the job of the Fed and tightening things up. This combination of higher real rates and easing inflation expectations looks like the current dominant trend, and which way

nominal market rates go will depend on which of the two dominates. Right now it looks like the rise in real rates is dominating, and the net re-steepening of the curve points in the same direction. Meanwhile the risk asset sell-off seems to be dampening inflation expectations most.

Central banks have hit a nerve

The stress in financial markets is spreading. It seems like the associated tightening of financial conditions has struck a chord with markets. As is sometimes the case, rates could be slightly ahead of the game here. The theory goes like this: markets, forward-looking as always, anticipate a slower path for growth as a result of aggressive central bank tightening. This pushes the valuation of risk assets down and bond yields up. The net effect is a cooling of economic growth expectations as financing costs and access to capital tighten.

The EUR and GBP front-ends have more downside



Source: Refinitiv, ING

The recent rally in front-end bonds suggests that, at this rate, the cooling effect on economies will be such that central banks will not need to hike rates as much as yield curves currently imply.

Sonia and Estr curves are both pricing roughly 100bp more tightening by the end of next year than we forecast

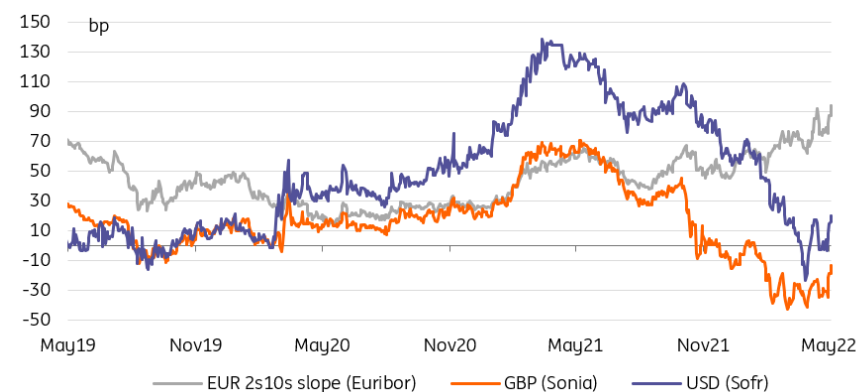
Regular readers know that we have sympathy with this view. The Sterling overnight index average (Sonia) and Euro short-term rate (Estr) swap curves are both pricing roughly 100bp more tightening by the end of next year than we forecast from the Bank of England and European Central Bank (ECB) respectively. This is a big gap that has persisted for some time, and that the Fed's hawkish tone has deterred investors from closing with confidence. That time may have come.

The key to further rate drops lies in China, and in inflation

Deteriorating Eurozone and US sentiment indicators today (see events section below) could continue to chip away at the central bank tightening narrative, but we think it is more likely the

prospect for protracted Covid-related disruptions in China, as highlighted by the rapid weakening of the CNY, that holds the key to market sentiment. Bear also in mind that the US CPI report scheduled tomorrow might reduce investor appetite to chase the bond rally.

Supply has a role to play in curve steepening, but so does the worsening growth outlook



Source: Refinitiv, ING

Further steepening would confirm that market confidence in central bank tightening is wavering

If consensus is correct, markets are in for a set of mixed messages tomorrow. A decline in US annual headline inflation could boost hopes that peak inflation is indeed behind us, but a higher core reading would push the Fed to continue its tightening drive. Our tactical view is that selling pressure on the long-end will continue at least until tomorrow, when most of the week's supply is out of the way. This is also a key reason for the sharp curve steepening seen since last week. Further steepening would confirm that market confidence in central bank tightening is wavering but we will reserve judgment for at least a few more days.

Today's events and market view

Sentiment indicators will feature prominently on today's release calendar. In the morning Germany's Zew will offer an early peek at May investors sentiment. Bloomberg consensus is for the expectations component to decline. In a context of accelerating central bank tightening and growing market turmoil, this would make sense. In the afternoon, US National Federation of Independent Business small business optimism is the main item on the list, with labour market conditions and pricing power the two most awaited components.

In bond supply, the Netherlands will sell 4Y debt, followed by Austria (6Y/10Y) and Germany (5Y). The US Treasury kicks off this week's supply round with a 3Y note auction.

There is also a long list of central bankers to go through. Of the ECB, Joachim Nagel,

Francois Villeroy, and Luis de Guindos will make appearances. From the Fed, John Williams, Thomas Barkin, Christopher Waller, Neel Kashkari, and Loretta Mester will speak.

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