Rates Spark: On edge, but risk perception calms

Risk has calmed and Treasury yields are edging higher again, as we head close to a big Wednesday (FOMC, TIC data and 20yr auction). In the eurozone, the 10y EUR swap rate remains confined to its 2.4% to 2.6% range as the Israel/Iran conflict only adds to a long list of uncertainties while at the front-end energy price risks keep the ECB on edge

Risk calms and Treasury yields rise as we head close to a big Wednesday

Volatility and credit spreads are on a declining path again. Developments out of the Israel / Iran spat are seen as either contained or manageable, with none of the worst fears for a wider impact materialising, as least not as of yet. US Treasuries broadly discounted as such from the very outset, preferring to home in on the potential inflationary ramifications rather than engaging on a safety play. This can cut both ways, and can manifest into a 'quality' flight. But so far the market has not been minded to morph this into a flight to bonds. Rather its been marked as a higher inflation risk and thus negative for Treasuries. The return of risk-on fits the same mold.

Ahead, the 20yr auction on Wednesday will be watched, as it tailed badly last time. At the same time, last week's 10yr and 30yr auctions went super well. Flows in the past week show some shedding of duration as a theme, and that can be gleaned from latest price action that is proving to be more heavy than seen in previous weeks. It seems when there is nothing front and centre to worry about that yields tend to creep higher, at least until we get some poor data to help pull yields back down again. The data in the coming days is mostly second tier, but still impactful enough to assess investor sentiment on direction.

Wednesday also sees the FOMC outcome, and we'll have the latest TIC flows data which will add some color to the appetite, or more likely the lack of it, as we progressed through a difficult period for Treasuries up until the tariff pause announced on 9 April. We expect to see some evidence of selling, but we doubt it will be as dramatic as some have predicted.

Even more uncertainty can delay a recovery in eurozone confidence

The conflict in the Middle East is yet another line added to the already long list of uncertainties facing the eurozone. Whilst of itself the direct impact may be limited, the headlines do not help with the recovery of confidence measures. Tuesday will give us the June ZEW surveys from Germany and the broader eurozone, which hopefully shows better numbers than the months before. For the growth outlook of the eurozone to brighten up materially, we'd have to see a more widespread improvement in consumer and business confidence.

Getting a better outlook on the eurozone's economic will need time and until then the upside potential for the back end of the swap curve will likely be limited. Higher oil prices are not good for the growth outlook either and thus the back end of the curve could find itself lower despite inflationary risks being on the rise. Iran's constructive view on further nuclear talks with the US helped oil lower again, but we still expect more price volatility ahead. Whilst the market volatility may not break the 10Y swap rate away from its 2.4-2.6% trading range in the near term, it can delay a move higher which we still anticipate later this year.

Tuesday's events and market view

During the European session Germany's ZEW for June will be the main indicator to watch with the consensus still seeing a further improvement, though some of the response will have come in ahead of the Middle East escalation. ECB's Villeroy and Centeno are scheduled to speak.

US data will take centre stage with the release of the retail sales data for May. We already know that auto sales volumes were down heavily in May, which will drag down the headline retail growth rate, while a soft ISM report suggests manufacturing is receiving little benefit from the current trade tensions. The consensus is looking for a 0.6% month-on-month contraction in the headline figure, but still a 0.2% rise ex autos. Other data to watch are the import prices as well as industrial production.

In primary markets the EU has mandated banks for a tap of the EU Oct39 bond, which should be Tuesday's business. Germany will auction taps of its 4y and 8y green bonds (€1.5bn) while the UK auctions 5y gilts (£4.5bn). The US auctions 5y TIPS (US$23bn).

Author

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

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

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