Rates Spark: Rates see near-term geopolitical risks averted

US data remains the main driving force for rates even as geopolitics have reentered the fray. A beat in retail sales pushed 10Y Treasury yields to new highs for the year. The further spike in market implied volatilities is also a reflection of the near-term almost binary outcome around geopoltical risks as markets still await Israel's final reaction

US data remains the main driving force

US data continues to be the main driving force of yields even as geopolitics have reentered the fray. Retail sales was another example of data beating every single forecast, and it helped push rates higher from the back end to new highs for the year. The 10Y yield reached 4.66% before headlines out of the Middle East nudged them back towards 4.6% again.

Markets are still leaning towards deescalation in the Middle East, but near-term Israel's pending decision about a possible retaliation makes for an almost binary outcome for markets via the risk channel. But a similar situation appears to arise surrounding every larger data release with regards to its implications for the Fed's policy path. Volatility seems all but ensured, and indeed markets implied volatility measures have increased noticeably over the past week.

Bund yields retrace risk-off move on Friday

Geopolitical risks add another layer of uncertainty to an already complicated situation for markets to navigate as Fed and ECB policies decouple. For sure a beat in the US retail sales data accelerated the move, but on Monday EUR rates retraced most of the risk-off move from last Friday when Iran's offense against Israel seemed imminent. The impact from the attack ended up limited and no response immediately from Israel materialised. However, headlines late in the European session suggesting Israel still sees the need to retaliate led to some renewed safe-haven asset flows, pushing the back end down. Overall, the 10y Bund yield ended at 2.43%, just 3bp shy of Friday's open.

Geopolitical risks will continue to drive markets this week, but markets do not seem positioned for a full-blown escalation of the conflict. With regards to the direct spillover channel posed via energy prices, the relatively muted moves in oil means that the pass-through to inflation is not of material concern for markets now, as also reflected by EUR inflation swaps being up only 10bp since the beginning of this year. Our commodity strategist notes that both the US and OPEC have capacity

Continuing on inflation risk, ECB Chief Economist Lane noted on Monday that broader measures of long-term inflation expectations have come down since last summer, together with the inflation risk premium priced by markets. Compared to 2023, the estimated inflation risk premium from 5y5y forwards has come down from roughly 60bp to around 30bp currently. But the trend down seems to have turned since US inflation started consistently surprising to the upside once more. The risk premium increase is subtle but does show that US-related inflation risks find their way through euro markets.

Tuesday's events and market view

The ZEW survey will be the one to watch given the drag of the German economy on the eurozone as a whole. The expectations component is seen improving and coming in positive again. But the assessment of the current situation remains at the lows last seen during the onset of Covid and consensus only sees this improve marginally. From the US we have housing starts and building permits data, together with industrial production and capacity utilisation later in the morning. In terms of UK data we have earnings, unemployment and jobless claims data. Consensus sees unemployment nudge up from 3.9% to 4.0%. Furthermore, plenty of central bank speakers to look out for, including Villeroy from the Banque de France and Powell from the Fed.

On the supply side we have the sale of a new €4-5bn Dutch 30y DSL via dutch direct auction (DDA), a 9y Gilt Linker auction of £1.5bn and Finland auctioning 5y and 31y RFGBs totaling €1.5bn.

Author

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

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

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

Disclaimer