Rates Spark: Real rates push on through 3%

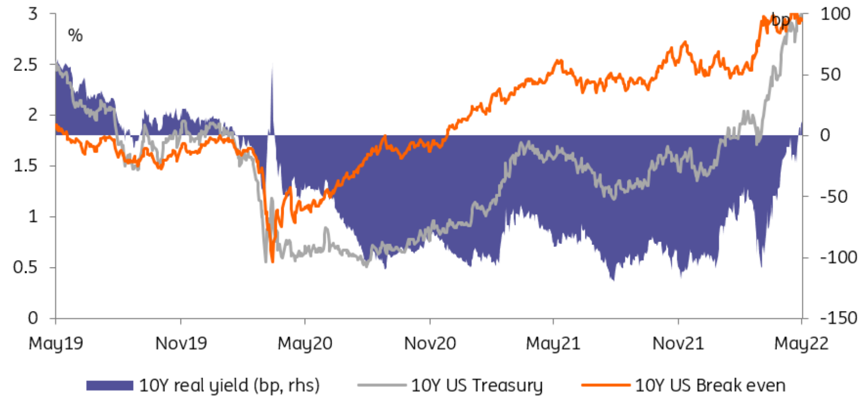
High US real rates paint an upbeat story. With a hawkish Fed setting the global tone even ECB doves concede that a first rate hike will happen rather sooner than later. But as focus shifts on the trajectory thereafter, the BoE's cautious outlook should help highlight the differences versus the US, and underpin the outperformance of GBP and EUR rates

The rise in yield is being driven by higher real rates, not higher inflation expectations, so far

The break above 3% for the US 10yr yield has not been driven by a rise in inflation expectations. At least not so far, which will give the Federal Reserve some degree of comfort, as they have hard-wired the market to 50bp hikes for the next two meetings. Even though that was an effective pre-delivery of an additional 100bp in hikes from the FOMC meeting, it was still less than what the market had discounted. In that sense it left the bond market a tad vulnerable, especially for longer dates.

However, inflation expectations in fact have been quite steady. Rather there has been a remarkable ongoing rise in US real rates, as the 10yr real rate motors on towards 20bp. Remember this was at -100bp in March, and the journey for the 10yr Treasury yield from 2% to 3% since March has come entirely from rises in the real yield. This is a signal for a firmer economy, and in fact representative of a selling in inflation expectations.

As long as 10Y break-evens stay below 3%, the Fed won't hike by 75bp



Source: Refinitiv, ING

> *The last thing the Fed would need to see now is a rise in inflation expectations*

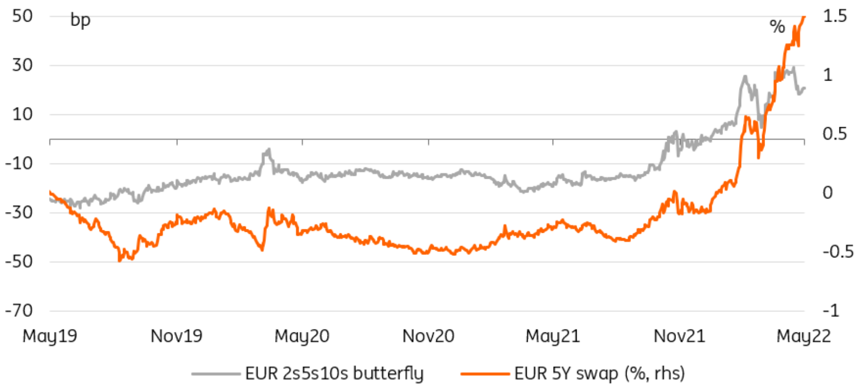
The last thing the Fed would need to see now is a rise in inflation expectations, as that would be a double whammy push higher for nominal rates. Our line in the sand is still 3% for the 10yr inflation expectation. Right now we are at 2.85%, which is high but tolerable at this juncture. And inflation expectations have in net terms managed to ease down since the Federal Open Market Committee outcome.

So despite some headlines to the contrary, so far so good for the Fed's stance. But if that 10yr inflation expectation were to reverse course and break above 3%, then there might be some more active talk on that 75bp discussion.

Don't let near-term rate hike discussions distract from the bigger picture

When it comes to rates beyond the very short term, there appears to be a habit of extrapolating from the discussions surrounding the details of a central bank's next move. When Fed Chair Powell suggested that the Fed wasn't actively considering 75bp moves, market rates adjusted noticeably lower. But this masks the fact that the Fed remains unwaveringly hawkish and that the level to which it wants to lift its key rate is probably affected very little by that discussion. We think markets are right to have backtracked the post FOMC rally.

5Y coming in on the EUR curve reflects an earlier, and perhaps shallower, hiking path



Source: Refinitiv, ING

Equally, European rates have paid much attention to European Central Bank commentary relating to the lift-off date. Hawkish comments have shifted expectations to a July hike by now. ECB arch hawk Holzmann yesterday said rate hikes would be discussed in June and the bank would then probably also act – we suspect by ending QE and signalling an upcoming hike. The doves on the council appear to concede that lift off may have to happen rather sooner than later given the inflation and general macro backdrop. Even members like Finland's Rehn now say rates should be hiked in July and the deposit rate should reach zero by autumn.

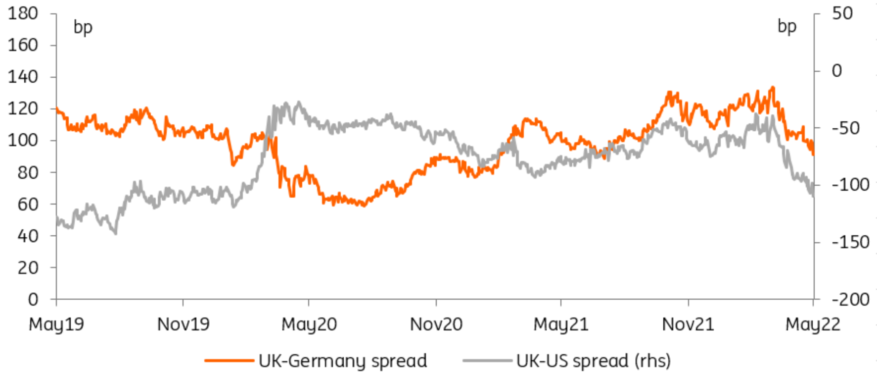
More important than the exact lift-off date is the trajectory thereafter

However, Chief Economist Lane has emphasised that more important than pinning down the exact month of the first rate increase is the trajectory from there on and where it ends. There are still good reasons for caution when it comes to moving beyond the initial "normalisation" of monetary policy, keeping in line with the ECB's stated gradualism and data dependency. If that notion were to gain more traction, then we suspect this would be reflected in the outperformance of the belly of the curve. Starting in the second half of April we already observed the 5y swap rates outperforming versus 2Y and 10Y.

The BoE is moving closer to the end of its hiking cycle

There is a growing sense that the Bank of England is closer to the end of its hiking cycle. It is not quite the end yet, though. There were two votes for a larger 50bp move yesterday when the BoE delivered its fourth rate hike taking the bank rate to 1%, and also our economists think there will be another hike in June and potentially also August

Gilts tightening to Bund and Treasuries is the canary in the global rates coal mine



Source: Refinitiv, ING

But there are also more hints that policymakers believe market expectations have gone too far, with two MPC members even suggesting the Bank should no longer signal further "modest tightening" was needed. The clearest message comes from the BoE forecasts itself, showing inflation below target at the three-year horizon, slowing growth and rising unemployment again by the end of the forecast period. The Bank also kicked the can down the road on prospects for actively selling bonds, which previously was slated to start when the key rate reached 1%. The committee has tasked staff with working on the strategy, and it will report back on this in August.

Despite BoE caution SONIA forwards see the Bank rate above 2.5% a year from now

Markets took note, and the reaction was indeed a dovish one with the Gilt curve bull steepening aggressively. 2Y Gilt yields dropped 9bp on the day, but despite all BoE caution SONIA OIS forwards still see the Bank rate above 2.5% a year from now. That is 100bp more policy tightening than our economist believes will eventually be realized. Showing that there is still a stronger global force to reckon with – that of an aggressive Fed – very long maturity Gilt yields still ended the session higher yesterday. However, that should not prevent Sterling rates from further outperforming versus the US going forward.

Today's events ad market view

With a growing sense that the BoE is nearing the end of its cycle, there is more potential for Sterling, but also EUR rates to at least outperform, even if the Fed still sets the global direction.

And Fed speakers will return in force today. This includes the Fed's Kashkari and late in the night Waller as well as arch hawk Bullard. Their comments may shed more light on whether Fed Chair's comments were actually intended to be as dovish as the market took them. Looking into next week, CPI data should not signal any relief. In the end, investor appetite at yields around 3% will be tested then as the US Treasury is slated to sell 3y, 10y and 30y bonds.

Today's main data point is the April US jobs report. Companies are still seeking to hire and it is a lack of available/suitable workers that is holding back employment growth. Consequently, wages are set to continue being bid higher with unemployment remaining at 3.6%.

As for today's supply, this comes from a smaller Belgian optional reverse inquiry auction of two bonds for total of €0.5bn.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com