Rates Spark: Time to re-focus

Higher US rates continue to pile the pressure on, and things are beginning to creak system-wise. Angst is rising. Central banks still pushing the hawkish message could see more typical bear flattening of curves again. Germany's repo announcement highlights shifts in supply-demand balances for Bunds with ECB quantitative tightening also looming

The stress barometers begin to ratchet higher in the US

Even though the Federal Reserve's Beige Book noted some moderation in labour markets and a moderation in activity generally, it did not note a large enough ratchet lower in price pressures as would be required to pivot the Fed from its rate hiking path. The 10yr Treasury yield now looks quite comfortable above 4%. It's been above before in the past week, but this move looks more decisive, a relentless and steady tick-by-tick, one-day-move, from 4% towards 4.15%.

Some weeks back we noted that a break above 4% was on the cards, and we followed that up by noting that Bank of England Gilt buying was nothing more than a short-term hurdle ahead of a re-break higher in US market rates. We've not seen these levels since 2008, just before US yields really lurched lower as the Great Financial Crisis (GFC) mushroomed. This latest move convincingly

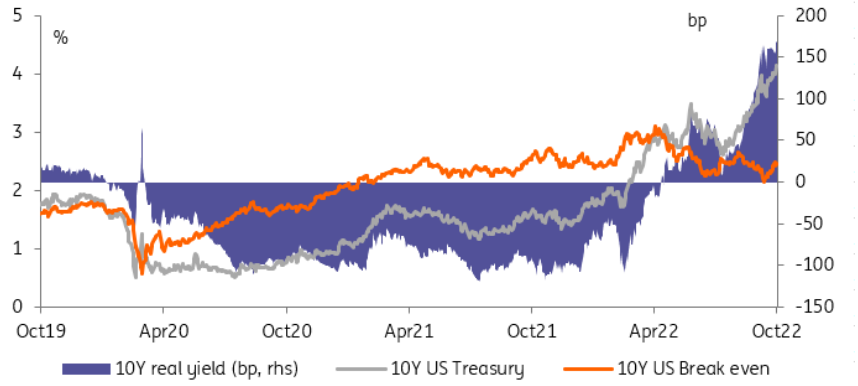
back above 4% for the US 10yr is yet more confirmation that the low-rates environment is very much behind us.

> *It seems the only way is up for market rates, until something breaks that is*

Even the US 10yr real yield is now threatening to breach above 1.7%, and in all probability will hit 2% in this cycle. That's really getting back to the kind of levels we were used to before the GFC. Remember, the US 10yr real rate was -1% at the beginning of this year. The approach of 2% means a 3% aggregate swing higher, an elevation that is quite dramatic. It is also something that can't be diversified away by corporates (like inflation can, to an extent). Hence it's quite painful right across the credit spectrum.

It seems the only way is up for market rates, until something breaks that is. We note that banks are beginning to pay up a little more for 3mth commercial paper, with many European names now paying 50bp over the USD risk-free rate. No material stress for now, but things are winding up some more.

Rising US real yields are a drag on risk appetite globally



Source: Refinitiv, ING

Calming UK turmoil allows refocus

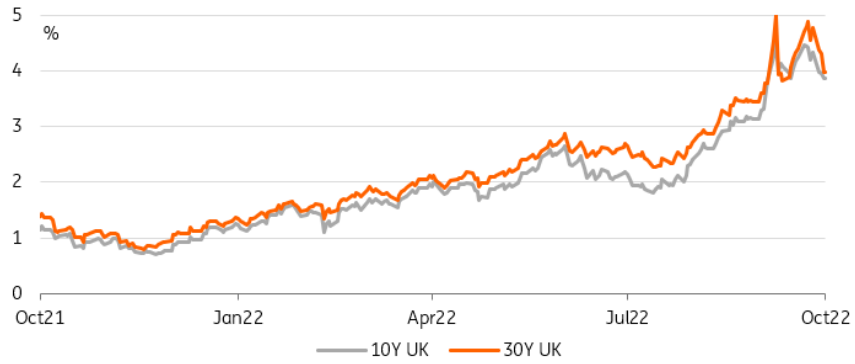
The developments in the UK allowed for a further relief rally in long-end Gilts with the Bank of England announcing it will spare the long end in the first phase of its active portfolio reduction and assurances from the BoE's deputy governor that pension funds were now coping with a 200bp increase in yields.

With the market tensions surrounding the liability-driven investment funds now "mostly behind us", this has allowed other markets to refocus on the issues at hand. The pricing out of a risk component in the wake of the turmoil probably contributed to the rise in rates outside the UK, but it is global central banks' main mandate to rein in unbudging inflation that remains at the forefront of market concerns. For now, that notion still trumps any signs of economic weakness as a driver of rates.

It is global central banks' main mandate to rein in unbudging inflation

Markets are braced for another 75bp hike from the Fed, with small chances for even a larger hike seen. In the eurozone, markets are equally seeing a strong case for another 75bp hike this month. And after the ECB's Bostjan Vasle suggested a further 75bp hike could be on the cards in December, the market discounting almost 140bp over the next two meetings does not look far-fetched. Most noticeable over the past weeks has been the shift of discussion to the shrinking of the ECB's balance sheet, with officials signalling that the groundwork for that to happen could be laid as soon as next week. In any case, the October meeting will be a crucial one with the ECB having a lot on its plate besides hikes. German 10Y Bund yields are closing in again on the intraday highs they had staked out alongside UK Gilts when they peaked amid the turmoil.

The BoE skipping long-end sales has injected fresh confidence in Gilts



Source: Refinitiv, ING

Germany announced €54bn in repo lending to finance energy support

Germany's finance agency announced yesterday morning that it would increase its own bond holdings by €54bn for use in the repo market. The debt agency cites the additional flexibility needed to cover extraordinary funding needs amid the government's measures to address the energy crisis. Yesterday's decision follows on the heels of an earlier €22.5bn issuance increase that was announced for the fourth quarter, already foreshadowing increased funding needs.

At the headline level, this decision should help to alleviate the collateral scarcity

At the headline level, the latest decision in particular should help to alleviate the collateral scarcity that is plaguing German government bond markets and has added to their extreme valuations

versus swaps. And indeed, the market's first reaction has been to tighten Bund asset swap spreads led by the front end.

Note that the debt agency has chosen to increase the holdings of 18 specific bonds that were "particular in demand" of the market. This suggests that the intention could be more to counter extreme cases of "specialness" in the repo market of individual bonds, rather than addressing the collateral scarcity more generally. We also note that the debt agency still reports own holdings of €141bn in conventional bonds, though we do not know to what degree they are currently already lent out.

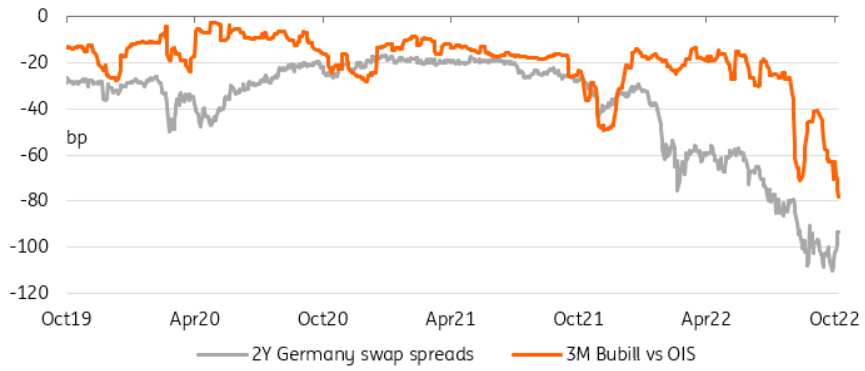
Has the balance finally tipped for Bund asset swap spreads?

Overall, Bund yields are still extremely low versus swaps, 96bp in 2y and around 88bp in 10Y. As much as some fundamentals are now tilting towards a tightening of the asset swap spread (ASW), with supply increasing and the ECB about to reduce its footprint in the market as well, other factors remain unchanged. One more technical factor we are keeping an eye on is the still large government deposits held with the ECB that could push into the market for collateral next year when they are no longer remunerated.

> *While collateral supply is rising, other factors pushing asset swap spreads wider remain unchanged*

More generally, the geopolitical backdrop still backs demand for safe-haven Bunds. Furthermore, the same ECB stepping away from the bond market can also raise systemic concerns, whereas in the eurozone, the concern centres on periphery bond markets. Record-high implied market volatility and rates near term still pointing up as central banks tighten the policy reigns, the directionality of rates is another factor that could well keep Bund ASWs at elevated levels.

3M Germany bills failed to ease in response to the additional collateral release



Source: Refinitiv, ING

Today's events and market view

EUR and US rates have taken a different direction from UK rates yesterday in a sign

of markets further moving on from the episode of stress that emanated from long-end Gilts. Near term that may allow for more bear flattening of yield curves more typical of environments where central banks are still engaged in pushing their hawkish message.

That said, it should become quieter on the ECB front as we now enter the blackout period ahead of next week's policy meeting. US markets still have to deal with a busy slate of Fed speakers. Relevant data also comes mainly from the US in the form of the Philly Fed index, initial jobless claims and existing home sales.

In primary markets, France and Spain will be active, both mainly selling shorter-dated bonds.

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