# Rates Spark: Shaping the narrative into summer

Amid broader risk sentiment taking a breather from recession chatter the 10Y US Treasury yield has climbed back to 3%. Today's jobs data is key to keeping that trajectory, though the curve could still tend flatter. ECB hike expectations also returned, but should not distract from a fast-closing window to deliver on hikes.


Flight-to-safety US Treasury bonds

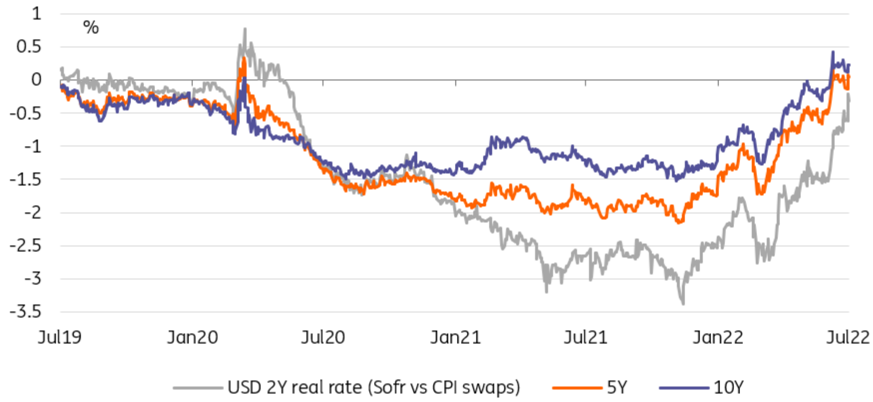
## US jobs are the first in a string of key releases shaping the narrative

A string of key releases ahead of the July FOMC meeting, starting with today's jobs data, will determine the market narrative ahead. A resilient job market will of course mean that the Fed can remain focussed on bringing inflation under control. Just how difficult of a task that will be should then be apparent with next week's inflation data. June CPI is expected to rise to 8.8% year-on-year, though the core measure should see some easing. The CPI release is flanked by the University of Michigan consumer sentiment data, including its surveyed inflation expectations as well as the producer price index.

*Expectations for a larger 75bp Fed move in July have already firmed again*

Market expectations for a larger 75bp move at the July meeting have already firmed again after the FOMC minutes earlier this week and following the hawkish remarks by the Fed's Waller and Bullard yesterday, who both advocated such a larger move. Markets are now pricing a total 124bp policy rate increase over the July and September FOMC meetings.

## A hawkish Fed has kept real rates high even as recession fears build



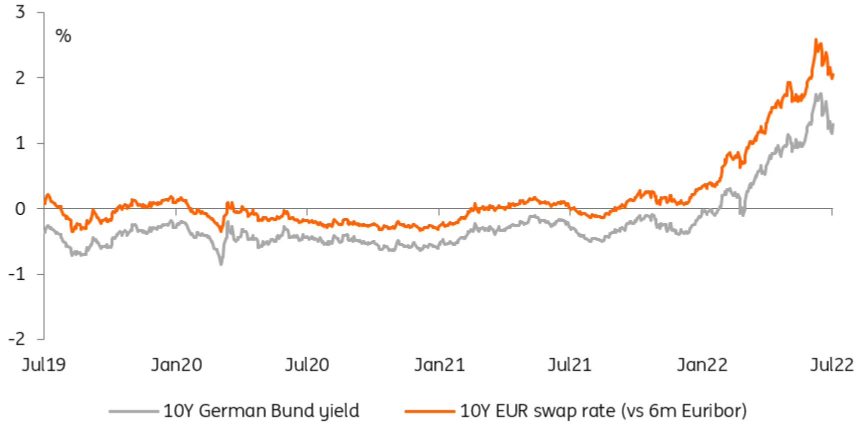

Source: Refinitiv, ING

However, perhaps the more important question that data will have to answer, with the Fed seemingly undeterred, is just how resilient the economy will be in the face of the Fed's aggressive tightening. While Fed expectations are again seen topping out at close to 3.5% at the beginning of the second quarter of 2023, rates are still expected to be cut by 50bp by the end of that same year. As an illustration of how hawkish the Fed is perceived to be, the latest drop in nominal rates has been more than matched by falling inflation swaps, keeping real rates at or near their highs. This shows that nominal rate upside has been reduced by easing inflation fears, and confirms that testing the June top will prove challenging,

## Beyond the near term volatility we look for lower rates

Rate hike expectations have also swept back into the EUR front end. Improving risk sentiment helped, but it was also the ECB accounts of the June meeting that left the door open to a larger 50bp move already in July. The Dutch Central Bank's Klaas Knot late in the day commented that the ECB's rate hike could come at a time of slowing growth. This serves to underscore the ECB's determination to bring inflation under control, but it also shows where the benefits of frontloading hikes lie. That said, our base case remains that of a 25bp hike In July.

## 10Y German yields and euro swaps set to move lower into mid-2023




Source: Refinitiv, ING

In the near term such hawkish tones, especially on the back of better risk sentiment can add to upside in rates, especially with a hawkish Fed in the background. Choppy trading conditions in euro rates should not distract from the bigger picture: a recession is coming and rates should be moving lower. Especially the adjustment of elevated hike expectations at the front-end should continue as the ECB's window of opportunity closes. Looking further ahead we see 10Y Bund yield settling 1% by this time next year as we have outlined in our latest forecast update. This is equivalent to 10Y swap rates dropping to 1.5%.

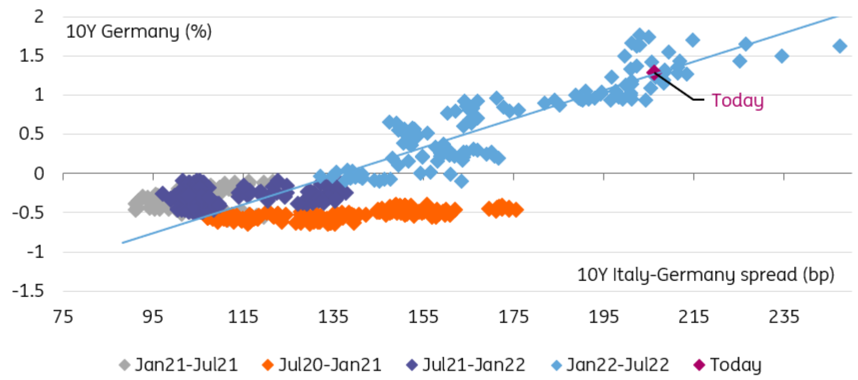
## No day passes without anti-fragmentation tool chatter

The ECB accounts added little to the discussion around the anti-fragmentation tool. The ECB appears to have outsourced that role to individual ECB members and less official channels. Officials remain vague on the details, such as France's Villeroy suggesting it will be large enough to contain spreads by its mere existence. Bundesbank's Nagel outlining his wish list of conditions earlier this week remains the exception. At least another Bloomberg story has now given us the name of the new tool - Transmission Protection Mechanism – but it also cautioned that the tool may not be ready to be unveiled in full at the July meeting.

*A credible backstop remains crucial to keeping spreads in check*

This is something we had suspected given the many contradictory reports, but we have also argued that besides the technical, legal, and political hurdles, the pressure on the ECB to act now has eased - with Italian spreads remaining below 200bp and comparatively tight other measures of credit risk or volatility. What we did witness yesterday though is that Italian bonds were not able to benefit from the general improvement in risk sentiment. A credible backstop remains crucial to keeping spreads in check.

## Lower Bund yields are also taking some of the widening pressure off Italian spreads




Source: Refinitiv, ING

## Today's events and market view

US markets will likely return to the driving seat with a string of key data releases, not only today but also in the week ahead. Today's June US non-farm payrolls are expected to come in at 268k, down from 390K in May, but with unemployment and wage growth. That should be more than enough to firm up current market expectations for the July FOMC meeting. Smaller disappointments should be reflected in doubts about the economy's resilience rather than in any change of the Fed's perceived near-term determination.

That said, EUR markets are also entering a week in which ECB officials will have the final chance to steer expectations ahead of the pre-meeting blackout period. With the ECB minutes having left the door open to a 50bp move already in July, we cannot fully exclude attempts to steer expectations in that direction. Some officials are likely to have an eye on the EUR exchange rate versus USD nearing parity. Today's ECB speakers include President Lagarde.

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