

## Rates Spark: Signs of optimism

Signs of optimism abound in global markets but caution remains. A Treasury short base explain the strength of the rally, but curve moves show the Fed's cautious message has landed. Easing collateral scarcity in Europe means swap spreads could tighten alongside riskier bonds



### A Treasury short base explain the post-CPI rally but markets remain cautious

Even with Thursday's post US CPI rally partially reversed, we find government bonds are at risk of a near-term retracement if US data continue to show pockets of strength. The most obvious risk is a disappointment in today's PPI release. Consensus is for a colling down of both the monthly and annual core (ex-food and energy) measures. CFTC data suggested that non-commercial future positions heading into last week's CPI were net short, and in the case of the 2Y, at a record level. This may account for the strength of the rally but data isn't timely enough to assess what percentage of these shorts were closed since.

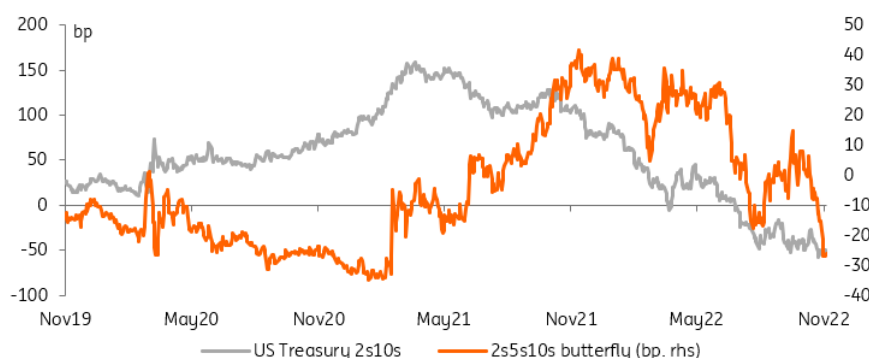
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*Non-commercial future positions heading into last week's CPI*

*were net short*

Assuming a short base still exists, the potential for a rally on a soft inflation print remains, although we think most near-term short-covering needs have happened since last week. Another development that is harder to explain with this positioning data alone is the failure of the US curve to re-steepen after the CPI release. Common sense would dictate that the 2Y would rally the most if data points to an early end to the Fed's cycle but it is the 5Y point that benefitted. This may suggest that the Fed's cautious message has been heard, and that markets believe it won't rush into cutting rates, which in turns means the 2Y could prove relatively sticky near-term.

## 5Y Treasuries dropped on the curve but 2s10s failed to steepen



Source: Refinitiv, ING

## Less collateral stress means swap spreads can join the risk party

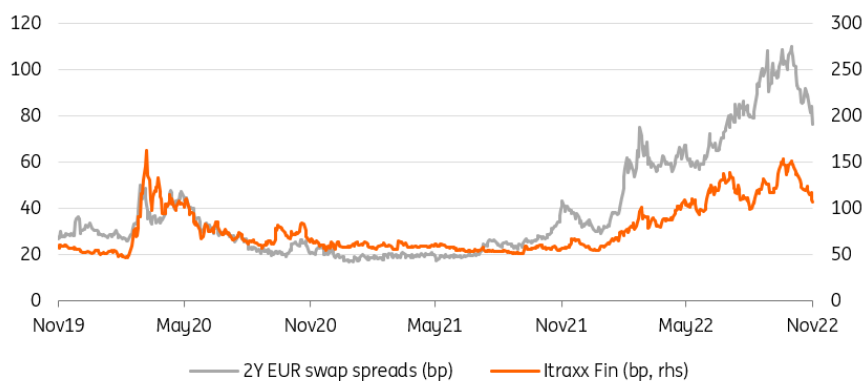
So far the strength of risk sentiment has failed to weigh on government bonds, in particular in Europe. The re-tightening of credit and sovereign spreads has failed to add to core yield upside which is characteristic of an environment where inflation remains the principal concern. In theory, this should weigh both on rates and riskier assets but the former is more directly impacted, so it is no surprise to see government bond yields stay range-bound even as stocks rally and spreads tighten.

*It is no surprise to see government bond yields stay range-bound even as stocks rally and spreads tighten*

Even the effect on swap spreads, an historical barometer of risk aversion, has been delayed. We've written repeatedly about steps taken by both the German federal treasury and the European Central Bank to ease the collateral shortage that has driven a wedge between the yield of German government bonds and swap rates. Large targeted longer-term refinancing operation (TLTRO) early repayments to be announced on Friday would add to this already well established dynamic. What lower collateral shortage would achieve is to make swap spreads more sensitive to other factors, including improving risk appetite, and so add to tightening pressure. This is assuming the

reasons for the improvement in risk sentiment holds up, however.

## Easing collateral scarcity is allowing swap spreads to tighten alongside credit spreads



Source: Refinitiv, ING

### Today's events and market views

Spanish and French CPI, as well as 3Q eurozone GDP will all be final readings. For more forward-looking indicators, look to Germany's ZEW sentiment index, also released this morning.

Frank Elderson, of the ECB, is due to speak today.

Euro bond supply will come from Germany (7Y), Finland (5Y/25Y), and from the EU which mandated banks for a dual tranche 10Y green and 30Y deal. The UK will carry out sales in the 10Y and 22Y sectors.

Given the magnitude of the post-CPI rally in bonds, today's PPI will be scrutinised for confirmatory signs that inflation is on the descent. For the same reason, the Fed speakers scheduled for the day will be of particular importance in dictating US rates direction. They include Patrick Harker, Lisa Cook, and Michael Barr. Empire Manufacturing completes the list of US releases.

We think the Treasury short base hasn't entirely disappeared but has shrank enough to reduce the risk of a rally. Meanwhile, supply should weigh on bonds until at least mid-week.

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