Rates Spark: Steepening from the back end

The steepening via the back end has resumed as the Fed's upgraded dot plot sinks in. Even if the market does not fully embrace the Fed's view, the current discount for the Fed funds trough is high enough to justify 10Y yields of 4.5% and higher. EUR curve steepened from both ends, but today's German funding update may put the focus on the Bund asset swap spread

The back end remains in the lead, in the US...

Bear steepening of curves resumed at the start of this week with the 10Y UST climbing above 4.5%. As this marks the highest yield level in 16 years, the closer guideposts are relative valuations. The 2s10s curve for instance has just straddled -60bp, but we have seen range-bound levels for some time around -50bp post March this year. We would argue a key relative metric is where the 10Y stands in relation to the trough of the discounted Fed funds trajectory, essentially the Fed's landing zone. If that stays around 4% then longer rates at 4.5% or even higher do not look out of whack.

The Fed's key message last week was the shift higher in the fed funds rate projection. Even at the front end this change still has to sink in to a degree with the market discount of around 75bp still higher than the Fed's 50bp. Of course this is all premised on nothing breaking in the meantime and data largely holding its poise. Therefore some scepticism seems only natural, but we have argued that it's the long end that has more room to adjust relative to the given front end discount.

Which is why data in the wake of the central bank meetings will remain key, and this week has quite a bit to offer. Foremost the personal income and spending data later this week, but also alongside the Fed's preferred inflation measure, the PCE deflator. Here our economist does see the risk of the monthly reading ticking higher again, similar to the upside surprise in the prior CPI release.

... as well as in EUR

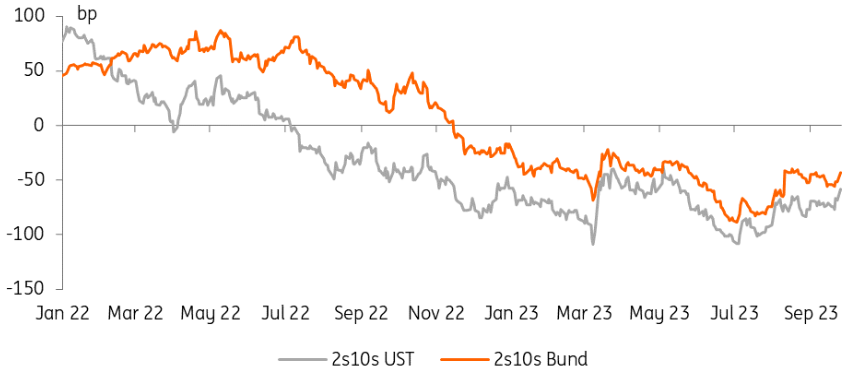
The bear steepening is not confined to the US. In Europe the 10y Bund yield briefly pushed past 2.8% and the 30y hit 3%. Interesting to note is that this happened with longer term inflation expectations actually dropping, so entirely real rate driven.

Risk assets of course are not liking it. In European sovereign space this has seen Italian bond spreads over Bunds prolonging their widening leg, taking the 10y spread to 186bp today. But overall widening was a moderate 2bp in relation to the 5bp outright move today, also considering it was largely directional widening since the start of this month. But at the same time that widening over the past week also happened alongside implied rates volatilities coming down, which should normally support spread products.

Implied volatility has picked up a tad over the past few sessions but still remain at their lowest since June. In part, it may be the explanation why Bund asset swap spreads (ASW) have remained relatively tight as they mirrored that broader move. That is still notable though, as a lot of the factors traditionally driving the Bund ASW are on the move, and pulling in different directions.

Risk sentiment as measured by sovereign spreads has been one factor, but its influence seems muted, with other risk measures like volatility being down. The European Central Bank's chatter about quantitative tightening has become louder, but the additional effective net supply that a speedier unwinding of the ECB's bond portfolios implies may take more time to actually realise. More near term, supply could actually still drop, when the German debt agency updates its quarterly funding plan today. And starting next week government deposits currently still sitting on the Bundesbank's balance sheet will no longer be remunerated and could hence push into the market for high quality collateral.

10Y yields are on long term highs, but the curves still have room



Source: Refinitiv, ING

Today's events and market views

The data calendar for the US already gets busier with the releases of house price data, new home sales numbers and the Conference Board consumer confidence survey as highlights today. The European data calendar has less on offer but we will see quite a few ECB officials making public appearances, including chief economist Lane and Austria's Holzmann.

Government bond primary markets will stay busier with a 10Y tap out of the Netherlands, a 5Y tap from Germany and Italian short term plus linker auctions. The main highlight will probably be the release of the German fourth quarter funding plan with cuts to the issuance target expected.

The UK taps its 10y green Gilt and the US Treasury sell a new 2Y note.

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