

## Rates Spark: taking the inflation blinkers off

Turning points are never easy. We look again at whether it is in already. It's a close call, but we are not sold on it yet. When rates markets take their inflation blinkers off, the world they contemplate isn't pretty. Central bank rhetoric should keep the pressure on the very front-end. Whether their message resonates with longer tenors is another question



Source: Shutterstock

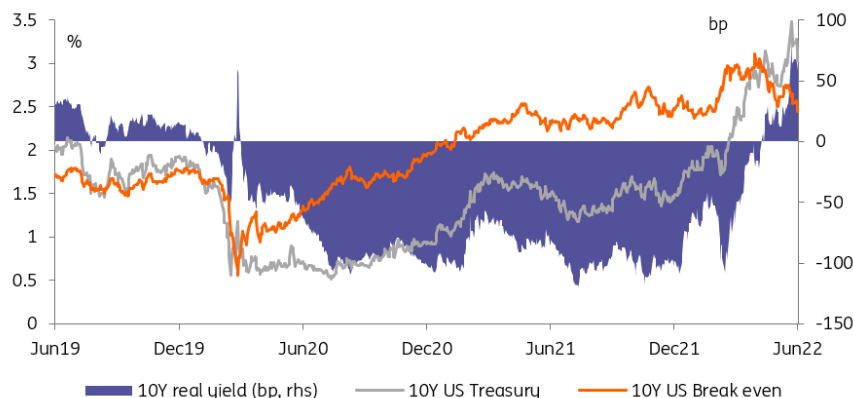
### US market rates are looking to mark a turning point. We are just not 100% sold on it just yet ...

The rally in Treasuries has been impressive. Nothing new from Chair Powell yesterday, just a follow-through from what we saw on the previous days. It certainly looks and feels like a turning point rally in bonds. But is it? The collapse in inflation expectations suggests things are coming off the boil. This will please Chair Powell.

The 10yr inflation expectation has dipped below 2.5%, a full 50bp below the peak hit before the May FOMC meeting. That was the one at which we believe that the Fed should have gone 75bp, but

they waited till the June meeting (post a big print). The July meeting remains a toss-up between 50bp and 75bp. Lower inflation expectations argue for 50bp. But keeping the downward pressure on inflation expectations argues for 75bp (our view).

## 10Y US real yields are still 40bp off our 100bp target



Source: Refinitiv, ING

Is that enough to justify a turning point? It helps. But we have two outstanding issues. First, real rates still look too low (by 40bp in the 10yr), and rises here should place some subsequent upwards pressure on market rates across the curve. Second, even though the 5yr has been decompressing, it remains cheap to the curve. Cheap enough to suggest that a turning point has not necessarily been seen. Our view is we're close. Very close. If the 5yr gives up and richens from here, then the turning point is likely already in.

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*A 40bp rise in real rates would push the 10yr Treasury back up towards its peak at around 3.5%*

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The macro element to this will come from the next CPI and payrolls numbers. So far there is no recession in the labour market. Any material change there changes everything. Note also that a 40bp rise in real rates would push the 10yr Treasury back up towards its peak at around 3.5%. But this would be muted should inflation expectations continue to fall. That argues for one more sell-off in bonds, but possibly without taking out the prior high, which would suggest the peak has been seen.

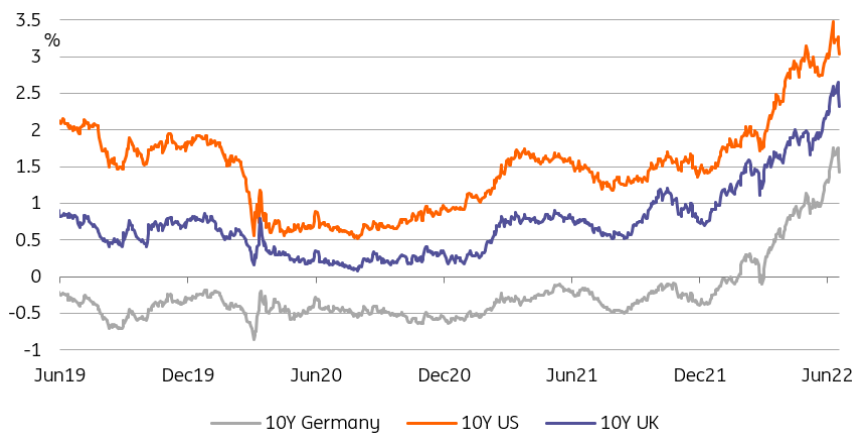
Watch the 5yr on the curve. That's the key. If it holds on to a stubborn cheap valuation, we can then take out the prior high in market rates in the coming number of weeks. Turning points are never easy.

## Rates markets wake up to recession risk

It seems bond investors took their inflation blinkers off this week, and considered the broader macro picture. The result wasn't pretty. A 23bp rally in 10Y Treasuries in two days. For 10Y Bund, the figure is even more impressive, 32bp. One has to admire the market's collective ability to

single-mindedly focus on one issue, inflation, at the expense of everything else...and to pretty much forget about it overnight. Whether markets have durably forgotten about inflation is another question. We doubt central bankers have. They could well cause a retracement of this week's rally.

## This isn't the first short-term rally in this bond market sell-off



Source: Refinitiv, ING

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*Recession fears have been bubbling under the surface for some time*

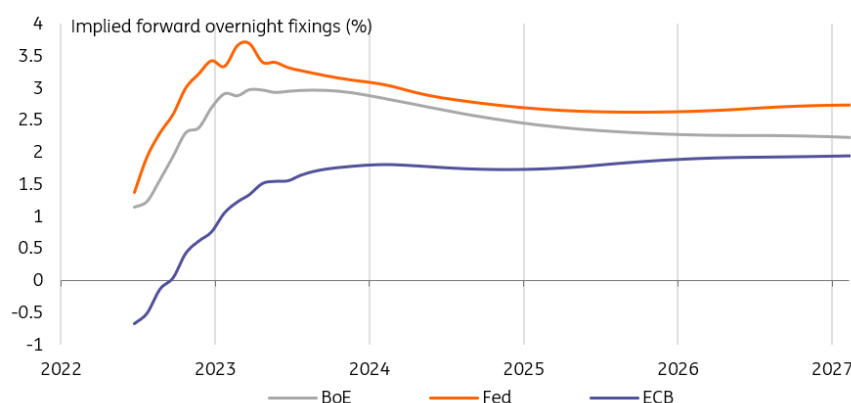
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Recession fears have been bubbling under the surface for some time now, so it comes as no surprise that European PMIs caught up with other sentiment indicators, such as Ifo and consumer confidence, in signalling economic angst. What's more surprising is that the bond market chose this time to reassess wholesale the degree of tightening it expects from central banks. In our view, the slide in some key commodity prices this month has helped snap expectations of ever higher headline inflation. Germany warning of a growing risk of gas shortage added to the economic gloom.

## Where is the pressure point on the curve?

To be blunt, rates have been leading central banks on the way up and they may well lead them on the way down too. If the market narrative durably shifts to recession at the expense of inflation fear, which isn't a given, then central banks' hawkish warnings will increasingly seem out of tune. The growing contingent of Fed members calling for a 75bp hike in July (with some still on the fence between 50bp and 75bp) is an illustration that hawkish rhetoric is here to stay, at least until central banks see tangible signs of declining inflation. We suspect European Central Bank comments at its Sintra forum next week will also cause some cognitive dissonance in rates markets, especially if June inflation fails to cool down.

## The 2023 part of European forwards curve is most likely to re-price lower



Source: Refinitiv, ING

*The curve could well flatten from 1Y point but re-steepen in longer tenors*

This hints at central banks delivering on hike expectations at the next few meetings, but feeling much less pressure to follow up by the end of the year. We suspect money market rates up to 6-12 months won't feel much downward pressure but subsequent tenors have the potential to reprice lower. As a result, the curve could well flatten from 1Y point but re-steepen in longer tenors. Comparing hike discount on OIS curves to our own expectations suggests that the USD term structure can flatten further, while the GBP and EUR ones have the most scope to re-steepen.

### Today's events and market view

Germany's Ifo survey result features prominently on today's economic calendar. A surprise dip in European PMIs yesterday coalesced with growing recession fears. The two generally agree but the Ifo is already painting a much less rosy economic picture than its PMI counterpart ever since the onset of the war in Ukraine, and rates markets have already re-priced a lot this week.

US data consists of University of Michigan consumer sentiment and new home sales. The latter is expected to stabilise at low levels while the former is a final update on the June figure that was seen as instrumental (alongside May CPI) in tipping the scales in favour of a 75bp hike at the June Fed meeting.

It will be interesting to see if the sharp repricing seen this week in rates has changed central bankers' thinking, especially with regards to recession risks. From the Bank of England, Jonathan Haskel and Huw Pill will step up to the microphone. Mario Centeno and Pablo Hernandez will give European Central Bank headlines an Iberian flavour. Mary Daly and James Bullard will be their opposite numbers from the Fed.

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