Rates Spark: Continue to play the end-of-war game

There is lots of noise out there about the ceasefire, and indeed something of a vacuum till negotiations actually begin on Saturday. But we continue to see enough to distil an outcome that ultimately sees the war conclude. The main bond market outcome is an extrapolation of a steepening impulse from both ends of developed market curves

We see enough out of the Iran ceasefire narrative to find an end to the hostilities

Base case, we expect to see a way through this whole mess

It's painfully slow, but we see enough out of the Iran ceasefire narrative to extrapolate an outcome that culminates in an end to these particular hostilities. As noted, this likely involves the US taking control of Iranian uranium enrichment while Iran retains some semblance of control over the Strait (even if in an acknowledged 'monitoring' role). As it is, we're in something of a vacuum, as the official negotiations don't start till Saturday. But with Israel now reaching out to Lebanon, it's clear that the US is paving the way for a final outcome. The fact that the Strait remains broadly closed misses the bigger point. As a stand-alone issue, this is of course not good. But this is not the end game. It's Iran pre-positioning ahead of talks. Base case, we expect to see a way through this whole mess.

The market reaction maintains a positive gloss overall. For US Treasuries, the curve is beginning to show a tendency to re-steepen. The path for the front end is lower yields as there is a price to be paid for the inflation angst now and ahead, which is ultimately negative for the economy. Meanwhile, longer-dated yields should be curbed from moving too much lower on account of the inflation risks ahead. The 5yr area of the curve continues to re-richen, which makes sense as the market nods towards Fed rate cuts to come later in the year. All the while, there is room for the curve to steepen, from both ends. Thursday's 30yr auction struggled while Tuesday's 3yr auction did better, fitting with the aforementioned steeper curve bias.

Friday sees the March CPI reading, and we are set to see a comfortable 3% handle on headline inflation. This is a clear repercussion of the higher oil and energy prices, and will remain a feature in the coming months as the impact of the higher oil price continues to feed through. Troublingly, core inflation (which excludes energy) will rise too, even if in a more moderate manner. The market *should* be expecting most of this. But even still, confirmation of higher inflation reminds us that it *is* a thing, and will remain so in the coming number of months. Market break-even inflation rates in fact anticipate a rise in US inflation towards 4%. A first step in that direction will be confirmed from Friday's inflation report.

Rebound from the initial spread tightening in EGB space has been rather muted

Oil prices remain more sensitive to lingering tensions and continue to gradually creep higher again. The feed-through to front-end rates via inflation and central bank hiking expectations remains more direct. EUR rates markets are again eyeing the possibility of the ECB hiking more than the 50bp, which has apparently become the baseline for this year.

Amid rates creeping higher, one could also be interpreted as a sign of caution, given that the Finnish sale of a new 10y benchmark attracted an order book only around half of the usual size for its past 10y deals.

However, beyond those indications of returning caution, overall market risk sentiment appears more ready to look through the crisis by now. Despite all indications that the ceasefire is a fragile one, this growing optimism perhaps rests more on the notion sinking in that US President Trump needs to appease a domestic audience, limiting his appetite to escalate further.

We observe that equities have not given up the gains on the initial positive news as readily with the VIX index actually staying close to its lowest levels since early March. And even in rates markets, we have witnessed a bear steepening. This bear steepening has gelled with a tendency of longer real rates also wanting to rise again, at least on the EUR side.

Also, as a sign of returning optimism, the rebound from the initial spread tightening in the EGB space has been rather muted. The 10y BTP/Bund was only modestly wider on the day. And more indicative of the markets pricing out severe tail risks was that Bunds have lost more ground versus swaps.

Friday's events and market view

The highlight will be US CPI data whereby markets are bracing for an increase from 2.4% to 3.4% for the headline number, while core is expected to rise mildly from 2.5% to 2.7%.

In terms of issuance, we have Italy with a 3Y, 7Y and 15Y BTP auction for a total of €8bn.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com