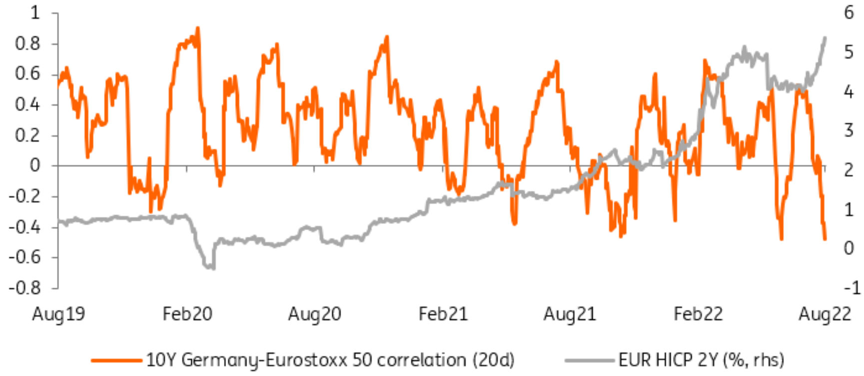
Rates Spark: The hangover

The hangover from this summer's Goldilocks/soft landing party is a brutal one. Most asset classes are selling off but history suggests that this can only last so long. At some point, bonds regain their status as safe havens – the question is when

'sell everything' markets are an unstable equilibrium

Current markets are characterised by a sell-off in almost every asset class, regardless of its degree of riskiness. Phases of negative correlation between bond yields and stock prices are relatively rare, and typically characterise regimes where inflation, rather than growth, expectations drive investors' behaviour. To illustrate this point, the relentless rise in European energy prices, for instance natural gas and baseload electricity, as well as last week's jump in UK inflation, have put price pressure back on the agenda. This in turn is prompting fears of central bank tightening, and so driving both bond yields up, at the safer end of the risk spectrum, and equity prices down, at the riskier end. In regimes where growth is the primary concern, or when inflation concerns ease, bonds regain their safe-haven characteristics, and their yields correlate positively with riskier alternatives.

Bonds lose their safe-haven status when inflation fears dominate

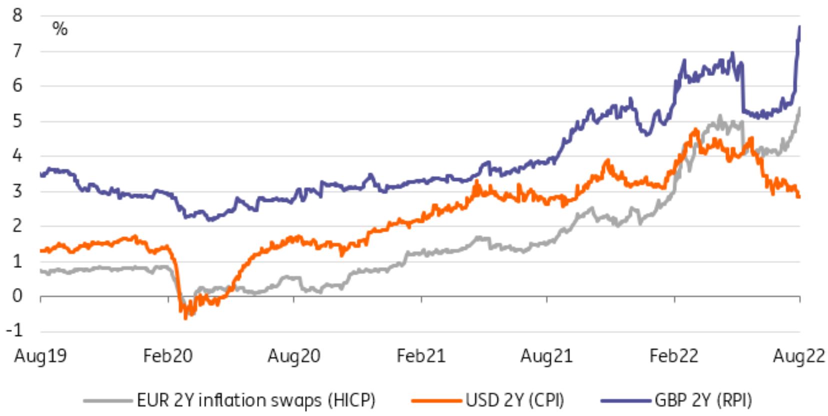


Source: Refinitiv, ING

Risk appetite is understandably in short supply as central banks struggle to get on top of inflation

All this is an attempt to make sense of the generalised rout in financial markets, but also to identify where it may end. Risk appetite is understandably in short supply as central banks struggle to get on top of inflation, but there is hope. For one thing, the surge in inflation expected over the coming months is mostly a regional development. Short-term EUR and GBP inflation swaps react to ever higher energy prices but their US counterpart have cratered. In periods of high volatility, it is understandable that the jump in European yields should push their US equivalent higher, but this dynamic has its limits. And indeed, we've seen a large divergence between EUR and USD bond yields already.

European and US inflation swaps are heading in different directions

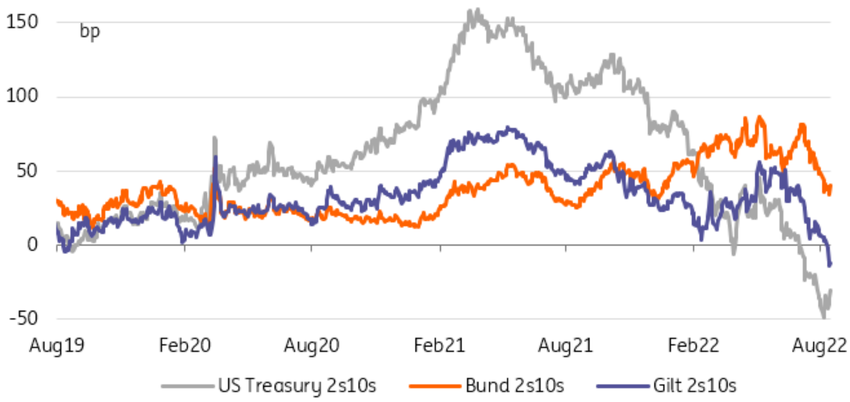


Source: Refinitiv, ING

The soft-landing scenario vs the European scenario

The current unstable equilibrium can be resolved in one of two ways. In the Goldilocks/soft landing scenario, tame inflation expectations reassure investors that at least the Fed will balk at hiking rates too high thus maintaining hopes of a soft landing. This should ultimately draw a line under the bond market rout. In the European scenario, lower growth expectations, which could worsen after today's PMIs, mean risk assets continue to underperform, thus directing safe-haven flows to bonds. This second scenario has an assumption baked into it, that European central banks will refrain from tightening policy in the midst of a severe recession. This is our view but one of the reasons for assets of all risk flavours selling off is the doubt that persists about their willingness to do so.

High inflation and slower growth should flatten European curves



Source: Refinitiv, ING

The Treasury curve should re-steepen on a relative basis, while its German counterpart converges to it

A clear objection to this simplistic view of the world is that markets should be able to have more than one concern at once, but we doubt that this is true if one looks at outright yield levels. This point is relevant for the shape of the curve, however. In places where the growth outlook is the most concerning, Europe, and where inflation looks most likely to spin out of control, Europe again, one would expect the curve to flatten. It is most interesting that the US has just seen a similar flattening move in the past few months, meaning the Treasury curve should re-steepen on a relative basis, while its German counterpart converges to it.

Today's events and market view

Of today's releases, August European PMIs will likely have the most import in investors' minds. Most indices are expected to dip below the 50 lines which should cause another flurry of recession warnings, but it is the manufacturing indices in particular that will be most closely watched. Concerns about energy availability, and prices, should rank high among survey respondents' concerns, and could aggravate the energy-led deterioration in risk sentiment. This will be completed in the afternoon by August consumer sentiment, expected to plumb to new lows.

Fabio Panetta is the sole ECB speaker listed for today. As a doves, his inflation warnings may not sound as stark as his colleagues but his endorsement of further tightening would also imply that the runway is clear for more hikes.

Finland mandated banks for the sale of a new 5Y bond aiming to raise €3bn. We think this should price today.

For UK-focused market participants, CBI orders and prices will add to PMIs in giving an idea of the economic direction of travel.

In the US, the Richmond Fed index will add a data point to a mixed set of regional surveys. This will completed by PMIs, as well as new home sales.

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