Rates Spark: The impact is no longer transitory

In our updated scenarios we see oil prices remaining elevated for longer in our base case, which could eventually weigh on growth and thus rates. In a tail risk scenario whereby the full supply disruption lasts until May, we even pencil in an ECB hike. But also, in this scenario, we end the year with lower rates

We see oil prices remaining elevated for longer and this should result in higher longer tenor market rates

The US 10yr yield heads to the 4.25%-4.5% zone, and then back down

As a consequence of the war to date, we are getting a feed of higher nominal yields, higher real yields and higher inflation breakevens. The 2yr breakeven inflation expectation is now at 3.2%. That's a market average in the coming two years. At the same time, longer tenor real yields are mostly higher since the war broke, which is in fact a sign of resilience. The profile ahead is prone to feature higher longer tenor market rates, with the 10yr nominal yield getting to the 4.25% to 4.5% range (now 4.2%), on elevated inflation expectations.

If, as we expect, the war is in a material wind down phase from April onwards and through the second quarter, we will be left with a structural elevation in inflation expectations still to deal with

(off the highs but still elevated), which will prevent market rates from falling back by too much. The 10yr yield does drift back down in the direction of 4%, but remains above.

In the "longer war scenario", real rates collapse lower as risk assets come under material pressure, on an elevated recession risk. Here the 10yr yield breaks back below 4% and gets down to the 3.75% area, or potentially lower (10yr SOFR gets down to c.3.3%). The inflation risk is still material, but the growth angst risk dominates in this more troubling scenario.

ECB hikes would significantly complicate the outlook for EUR rates

Similar to USD rates, the picture turns complex for euro rates when energy prices stay elevated for longer, especially if this forces European Central Bank rate hikes. The immediate impact of higher inflation and policy rates is a push upwards for the entire euro swap curve. But the risk is that the growth outlook turns more negative due to higher energy costs and tighter monetary policy.

In response, markets could actually start pricing in significantly looser monetary policy after the initial inflation shock. Alongside deteriorating market risk sentiment, such a scenario would bring down longer-dated rates materially. We see the 10Y swap rate fall back to 2.6%, but that number could very well be lower depending on global risk sentiment and the broader macro outlook.

Tuesday's events and market views

A relatively light day in terms of data and thus geopolitics will likely continue to drive markets. From the eurozone we have ZEW survey data for Germany for March. Consensus already pencils in a strong decline from 68 to 39 for the expectations component. From the US we have the ADP weekly employment data.

In terms of supply, we have the UK auction a 5Y gilt for £4bn and from Finland we have 6Y and 9Y RFGBs totalling €1.5bn. The UK will auction a 20Y bond for a total of $13bn.

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