

Rates Spark: The party goes on

The rates rally is extending, but also looking increasingly stretched, especially in the euro area where 10Y Bunds are back below 2% and 2023 European Central Bank rate cut expectations are creeping in. Today's session holds fewer data to feed the rally, and we might get more pushback from the ECB against the notion of slowing hikes



The belly of the curve leads the rally as the focus increasingly turns to Fed cuts

The bond bulls got all they could hope for yesterday to extend the rates rally with US dictating the way. The 5Y part of the curve led the way lower in Treasury yields dropping by more than 18bp on the day, and the 10Y yield dropped below 3.40% in a session capped off by a strong 20Y auction.

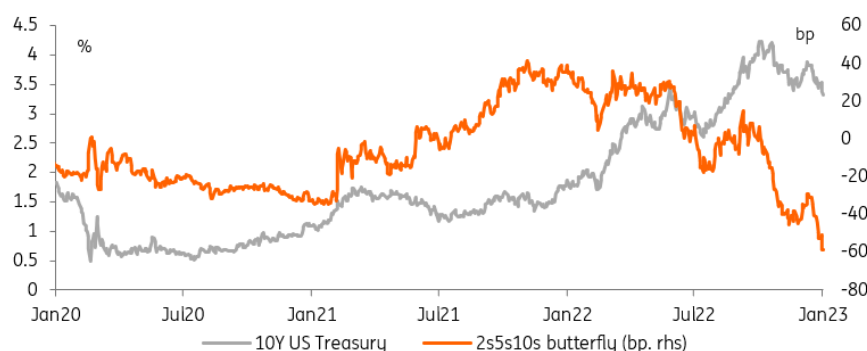
The BoJ and softer US data provided the backdrop for a further bid

Certainly, the [Bank of Japan leaving its policy of yield curve control in place](#) paved the way for lower rates ahead of the session, US data later provided the backdrop for a further bid. [Softer-than-expected retail sales](#), a producer price index hinting at weakening pipeline inflation pressures and [a miss in industrial production data](#) suggest that the Fed is close to the end of its hiking cycle

with recession on its way.

Near term the market is now homing in on a 25bp hike from the Fed at the February meeting and the possibility of another hike following in March. This implies the peak of the Fed funds upper bound target rate at 5%. The Fed hawks Bullard and Mester were making the case for tightening policy rate beyond 5%, but the market easily glossed over their comments also given that in the Fed's own survey, the Beige Book, contacts reported expectations of further moderating price growth. The focus is increasingly turning to the first Fed cuts, 50bp in total now discounted for the second half of the year.

The 5Y sector is rallying faster than other maturities, indicating growing cut expectations



Source: Refinitiv, ING

The rally spills into EUR rates, but might receive more pushback today

EUR rates rallied alongside US rates with the 10Y Bund yield dipping below 2% for the first time since mid-December. The EUR market obviously had its own dovish ECB sources story this week to underpin the rally, but that story has received pushback in ECB officials' comments yesterday. With an eye on the keeping financing conditions sufficiently tight to rein in inflation, ECB officials possibly see their earlier efforts of decoupling its outlook from the Fed at risk.

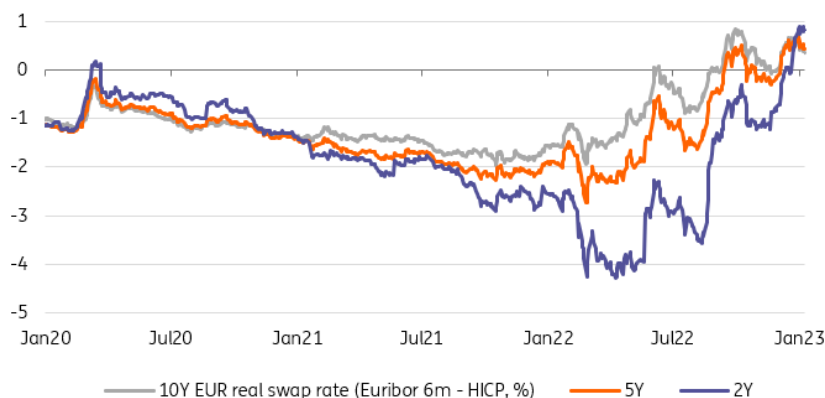
Earlier efforts of the ECB to decouple itself from the Fed are at risk

France's Villeroy stated that the President's guidance from the last meeting for a series of 50bp hikes was still valid. Similarly, Finland's Rehn said "significant interest rate hikes in the near-term monetary policy meetings are justified", arguing it was too early to speculate about the pace of hikes after March. Today we will hear from the ECB President herself when she speaks in Davos.

Equally as impressive as the outright rally in EUR rates was the further tightening of intra government bond spreads. The key 10Y spread between Italian government bonds and the German peers briefly dipped below 170bp, the tightest since April last year. Back then the ECB already flagged its intention to wind down asset purchases, but it was still ahead of the rate hikes and any plans of quantitative tightening. 250bp of hikes later with another 125bp likely to come

and balance sheet reduction well under way, that is an impressive feat. But keep in mind, even EUR markets are now pricing in the prospects of first ECB rate cuts for the second half of this year.

Real swap rates haven't yet eased financial conditions but tighter sovereign spreads have



Source: Refinitiv, ING

Today's events and market view

Rates markets are on a run. Events and data have given at least US rates good reason to do so, though we think that levels are becoming more stretched. Technical factors like the historically wide gap between the Fed funds rate – still set to rise near term – and the 10Y yield suggest building upward pressure. But there is also an underappreciation of inflationary risk coming from a re-opening China and we have also not seen the last chapter of the BoJ story. But it is especially in the eurozone we think the spilling over of rate cut expectations looks overdone.

Today's data calendar features housing data, initial jobless claims and the Philadelphia regional Fed index in the US. There is little by way of data in the euro area, but we will get the accounts of the December ECB meeting in which the central bank delivered a 'smaller' 50bp hike than at the previous meeting, but with a hawkish twist. Quantitative tightening was kicked off and President Lagarde hinted at more 50bp hikes to come. This puts particular focus today on her scheduled appearance at the Davos Economic forum. With ECB's Klass Knot there is also another ECB hawk who could push back at the notion that the pace of hikes could be slowed in March.

In primary markets we will see France and Spain with auctions today.

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