

Rates Spark: The running of the bond bulls

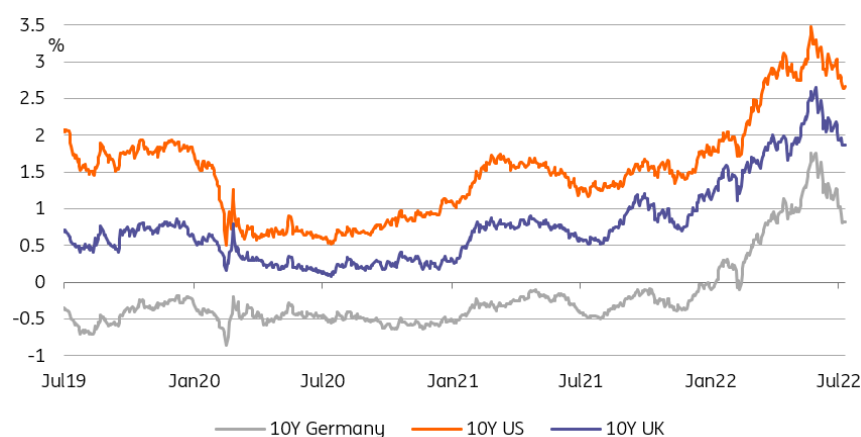
We see more downside to market rates as recession fears boil over, and as bonds regain their safe-haven status. 10Y Treasuries touching 2% again this year, and 0.5% for 10Y Bund, is not excluded but this week's events pose risks to this view



More downside for core yields into year-end

The performance in core government bonds since the onset of the summer has been significant, and we expect it to continue. In short, our argument centres on two points. First, yield curves, in particular in the eurozone and in the UK, still price 50bp more tightening from their respective central banks than our economics team predicts. This is much less than the gap in the middle of June (over 200bp), but this could still be feeding into lower long-end rates over the summer as markets converge to our view.

Bond yields are plunging towards their March levels



Source: Refinitiv, ING

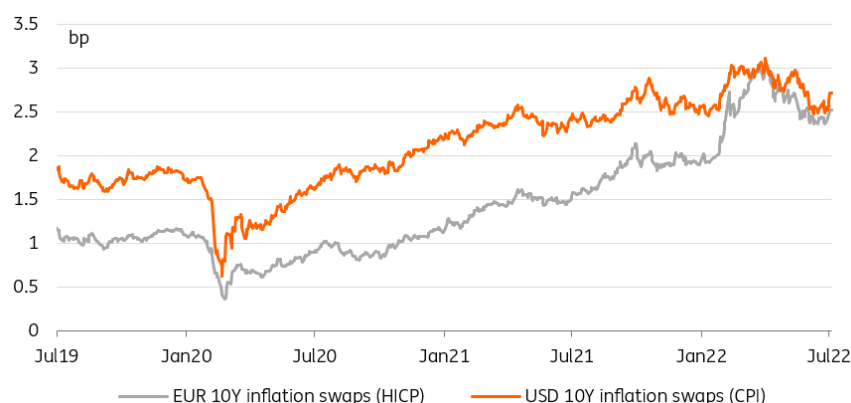
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Our second argument is the regaining of interest for recession hedges – assets that perform well when riskier options tank. The return of negative correlation with risk assets, and more importantly, receding inflation expectations, are helping government bonds regain their status as safe havens. Both factors could push 10Y yields to levels not seen since 1Q: 1.5% for gilts, 2% for Treasuries, and 0.5% for Bunds. These levels could be seen when recession fears reach their peak. We doubt they can be sustained for long, however.

What could possibly go wrong

This view may seem outlandish in light of the hawkish frenzy that took place in financial markets in 1H 2022 and, indeed, risks abound. This week, we would rank a higher-than-expected July US non-farm payrolls, as the main threat to our view. Our [economics team expects](#) supply constraints to slow down US job growth, but look elsewhere for signs of loosening of the US job market.

Dovish central banks could re-ignite inflation expectations



Source: Refinitiv, ING

We also cannot exclude hawkish risks from Thursday's Bank of England meeting. Even with the market converging to our view that [the MPC will opt for the larger 50bp move](#), our bullish gilt view is at risk. We think this is a temporary one, however. Hawkish soundbites, as well as signs of hotter-than-expected price dynamics have typically been greeted by yield curves as a flattening signal, most notably at last week's FOMC. In other words, it is entirely possible that a hawkish surprise pushes front-end yields up, but fails to propagate to the long-end.

Risk assets ripping higher and a better risk mood music could soften safe-haven demand for bonds

The last risk is more endemic to financial markets. The drop in both nominal and real yields, and the rally in risk assets in July, all point to pared down central bank tightening expectations. Risk assets ripping higher and a better risk mood music could soften safe-haven demand for bonds. There is also the risk that central banks decide to push their hawkish messages more forcefully, as Neel Kashkari did when he warned against markets declaring a too early victory in the Fed's fight against inflation. Hawkish comments have been met with a shrug lately but if they really want it, central banks can regain control of the long-end, at least temporarily.

Today's events and market view

Of today's PMI manufacturing indicators, only the Dutch, Spanish and Italian indices are first releases. Their US equivalent, the ISM manufacturing, stands a better chance of influencing financial markets direction. Construction spending is another indicator to watch.

The first day of each month tends to be slightly less favourable for duration as month-end buying fades, bonds can count on an assist from a miss in China's manufacturing PMI overnight and in Germany's retail sales to boost safe-haven demand, however.

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