Rates Spark: To the brink and back

Just when markets feared the worst, renewed hopes of an end to the conflict pulled them back from the brink. While central bank pricing has eased from extremes, it remains aggressive and likely to stay that way, given persistent uncertainty and limited liquidity in many markets

Markets expressed a sigh of relief after President Trump postponed strikes on Iran's energy infrastructure

Renewed hope, but not the all-clear required to turn the market

At one point on Monday, the market was almost fully discounting four rate hikes from the European Central Bank this year, with a hike already in April fully priced. At the longer end of the curve, the 10y EUR swap rate moved past the 3% threshold with a muted reaction to the real rate, suggesting that the main consideration here was still the inflation feed-through.

However, elsewhere, the knock-on effects of such extreme pricing were felt more painfully. And this did hint at tipping points coming closer. The 10y BTP/Bund spread surpassed 100bp, a more than 10bp widening of the spread versus the end of last week. Bunds outperformed swaps in short-to-intermediate tenors, which is usually a clearer sign of flight to quality.

It was only after the headlines that Trump had postponed strikes on Iranian energy infrastructure that the market turned with a sigh of relief. The headlines about talks with Iran being resumed offer some hope for an end to the conflict.

Still, energy prices remain elevated, and so does market pricing of central bank tightening. The implied probability of an ECB hike in April still sits above 50%. Given the limited additional information that the ECB is likely to have at that point in practice, that still looks like a stretch to us. The eurozone flash PMIs today could rather highlight the downside to sentiment coming from the turmoil. Given that uncertainty around the conflict remains high and liquidity in many markets limited, the lack of conviction to take the other side of the trade can keep market pricing lingering at these seemingly stretched levels.

Tuesday's events and market view

In terms of data, the release of the flash PMIs for March is the main event. Manufacturing PMIs are seen as the most vulnerable to fallout from the geopolitical turmoil, with consensus expecting the eurozone index to slip just below the 50 threshold. In the US, we will also have the release of the weekly ADP employment change.

The key focus should be on the various central bank speakers. The ECB's Kocher, Sleijpen, Cipollone and Lane are scheduled to speak. In the UK, the BoE's chief economist, Huw Pill, is due to speak, while in the US, the Fed's Michael Barr is expected to speak on the economic outlook.

Eurozone government bond supply will come from the Netherlands auctioning 30y bonds (€1.5-2bn) and Germany selling 5y bonds (€5bn). The UK auctions 10y gilts (£2.25bn), while the US sells new 2y notes (US$69bn).

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