Rates Spark: Transmission issues

A weak US sentiment index failed to snap the curve flattening trend, as markets keep their powder dry ahead of labour market data. Attempts to engineer a steeper euro curve are set to result in greater risk premia elsewhere

Curve flattening remains the market's default mode

The fall in the June US ISM Manufacturing from already worrying levels at least prevented US yields from mounting another attempt at rising to new post-SVB highs. One has to wonder how much appetite for new risk there was in a reduced hours session yesterday and ahead of the Independence Day holiday today. More fundamentally, despite conventional wisdom suggesting that the manufacturing sector provides an early read of future activity, markets have been wrong-footed before. We wouldn't be surprised if some investors kept their powder dry ahead of the more immediately relevant labour market indicators due to be published on Friday.

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Probably also due to the market's focus on labour market indicators, the ISM release didn't allow the curve to snap its flattening streak. Besides the, justified in our view, macro rationale for the move, such a notable tendency to flatten regardless of rates going up or down suggests heavy flow in that direction. The new Bank of England (BoE) member Meghan Greene was also responsible for adding some hawkish fuel to the fire in an FT column.

Unless it replaces rate hikes, QT stands little change of re-steepening the curve

Source: Refinitiv, ING

Order a steeper curve, get wider spreads

Her main point however, if correct, doesn't necessarily scream curve flattening. In a nutshell, the new central banker pointed to the risk of a higher R* post-Covid, suggesting the assumption that inflation and rates will eventually fall to their pre-pandemic range may be misguided. Two interpretations ensue. In the short term, the comments suggest the BoE will err on the hawkish side rather than rely on mean-reverting models to forecast a fall in inflation. The longer-term implication is that a deeply inverted curve, premised on a relatively quick reversal of the current hikes, isn't justified.

Hawks appear to be succumbing to the temptation to accelerate QT in order to transmit higher rates to the back end of the curve

Given central banks' track record in forecasting inflation, we do not blame markets for focusing on the near-term implications. We'll hear from Joachim Nagel and Yannis Stournaras today, respectively ECB hawk and dove. It is fair to say, also in relation to the inverted curve, that hawks have won the argument. Recent comments suggest hawks are now succumbing to the temptation to accelerate Quantitative Tightening (QT) in order, perhaps, to transmit higher rates to the back end of the curve. The US and UK experience with QT, albeit different in some respects, suggest this is a tall order. Our view is that such comments would more likely affect risk premia across markets, from currently moderate levels.

Today's events and market view

US markets are closed for Independence Day today so the responsibility of feeding market-moving developments will fall squarely on Europe's shoulders. Unfortunately, the only data scheduled after the European open is Spanish employment.

Bond supply will be lively on the other hand. The UK will sell £2bn of 30Y green gilt via auction. Austria will also be active in long-end primary markets, with 10Y and 30Y auctions. Germany is scheduled to sell 10Y inflation-linked debt.

Joachim Nagel and Yannis Stournaras, sitting at opposite ends of the ECB's hawk-dove spectrum, are the two central bankers listed for today. Markets have been more sympathetic to the hawkish argument of late but the Reserve Bank of Australia's decision to keep rates unchanged overnight shows tighter policy could also be achieved through a much slower hiking pace.

Author

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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