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# Rates Spark: Turning into a rout

This bond bear steepening market is being driven by Treasuries, and more specifically by higher longer tenor real rates. This is painful for corporate borrowers, as higher real rates cannot be diversified away through higher prices (as could be the case if driven by inflation expectations). This puts pressure on credit markets as a result



## Too far, too fast?

It's messy out there. It's not often you get a 10bp uplift in the 10-year yield in one day. We had one yesterday. And we've had over a 50bp upmove in the past three weeks. It's now at 4.8%, and looking like it's gone too far too fast. But if we don't look down, that 5% level could be with us quite quickly. It's clear also that Treasuries are a dominant driver out there. It's pulling other yields higher, is hurting equities, and is pretty immune to influence from risk off.

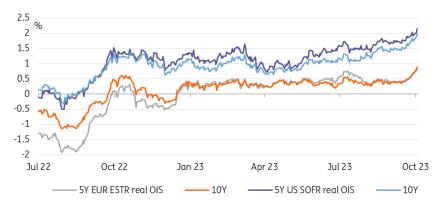
Typically, a severe enough risk-off event would put some counterflows back into Treasuries. And there have been some. Right through the rise in yields in the past couple of months there have, in fact, been net inflows into Treasuries. But this has not been enough to dominate price action. In fact, prices have moved first, not so much in reaction to flows, but in anticipation of them. And of course in reaction to data that continues to show the US economy continuing to defy recession worries.

The JOLTS data are a case in point. This measure of "job openings" had been coming off the pandemic sugar high which saw them peak out in the 12 million area. A huge level. It compares with a long-run average in the 2.5 million area. It had been falling since mid-2022, and got to below nine million last month. But the latest month shows a pop back up towards 10 million (9.6m). That's a remarkable move in light of the inflation/rates/sentiment headwinds that arguably should be impacting the economy more.

And the curve continues to pull steeper (dis-inversion). As we ended the summer, the 2/10yr was in the -75bp area. It's now half that, and just 35bp away from breaking back above zero into positive territory. It's been pulled there by higher longer tenor real rates. The 10-year real yield is now knocking on the door of 2.5%, having been below 2% only a few weeks back. And importantly, inflation expectations are broadly steady. This angst mode has been driven entirely by higher real rates, and signs of underlying macro strength.

Note, however, that higher real yields are also more painful than ones driven by higher inflation. The latter can be passed on through higher prices at the corporate level. But higher real rates are more difficult to "pass on". They are essentially a tax on the borrower that must be paid to get any type of re-funding done. That is arguably where the next vulnerability lies. Risk assets are reacting to this, but there is the potential for more pain here ahead, especially in the guise of wider credit spreads.

### Real rates are pushing higher



Source: Refinitiv, ING

# Longer EUR real yields also at highs, Italian spreads resume widening

As US Treasury yields surged for another day Bund yields got pulled higher, ending just below 2.97% and thus still a sliver below last week's highs. What we noted at the start of the week still held yesterday – inflation swaps are edging lower. This means that the rise in real yields is more severe.

2-year real ESTR OIS rates are above 1% but have not quite taken out the July peak yet. 5-year real rates have passed the peak with the start of this week surging to 0.8%, while the 10-year at 0.83% already broke above previous highs last week. The European Central Bank hawks, such as Isabel Schnabel who typically has an eye on this indicator as a measure of effective financing conditions, may see this as necessary tightening to counter inflationary pressure.

In Italy, the sale of the BTP Valore bonds extends into its third day. Days one and two saw strong demand with orders accumulating to €9.3bn, and this is on track for a final volume in the ballpark of €15bn by the end of the week. Nonetheless, the widening of Italian government bond spreads resumed. The key 10-year spread versus Bunds topped 190bp again and thus more than offset Monday's recovery.

The directional nature of the spread certainly made it tough to withstand the rise in outright rates, but we also got more hawkish ECB talk on potentially ending the reinvestment of the Pandemic Emergency Purchase Programme portfolio sooner. We would note that even the likes of Austria's Robert Holzmann acknowledge that the flexibility of reinvestments is an important backstop to spreads. He suggested that the staff would look into how to maintain that flexibility even when reinvestments are slowed.

# Today's events and market view

There seems little in the way to stop yields from rising further. Data only accelerated the sell-off over the past few sessions but could turn out to be a bit more of a headwind today, that is, if expectations about the ISM services are right. That index is seen easing back somewhat, although still staying in expansionary territory. The other data point to watch is the ADP payrolls estimate, though it has a patchy track record of predicting the official numbers two days later.

Over in Europe, the main releases are the producer prices, retail sales and final services PMIs, including some first readings for individual countries such as Spain and Italy. Attention will also fall again on ECB speakers, this time including President Christine Lagarde, Vice President Luis de Guindos and from the very dovish end Fabio Panetta.

In sovereign supply, we will see the continuation of Italy's BTP Valore sale. Germany will tap 7-year Bunds for €3bn while the UK sells 2-year gilts for £4.25bn. In SSAs, the EFSF mandated banks for a new 5-year bond and a 10-year tap, which should be today's business - and the EFSF's final issuance for the year.

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