Rates Spark: Autopilot into the gloom

The UK Gilt market sell-off in long dates is reminiscent of crisis conditions of old, but some things never get old. We don't see current levels as an obvious level for the bond sell-off to stop; it is likely to take a few months for investors to want to increase their exposure again. This is morphing into an uncontrollable set of circumstances

The UK 30yr Gilt yield is up 100bp in two trading days, and no we've not fat-fingered an extra zero; it's literally up 50bp per day in the past couple of days to 5% now!

If you weren't following the Gilt market and did not know the level you'd be forgiven for retorting that it was too low to begin with given where inflation is (10%). That may be true, but where does that leave the US long bond yield then? It's higher but still below 4%, with US inflation at 8%! The very poor US 5yr auction yesterday and the 2yr on Monday, show that investors are not viewing current levels as concessional.

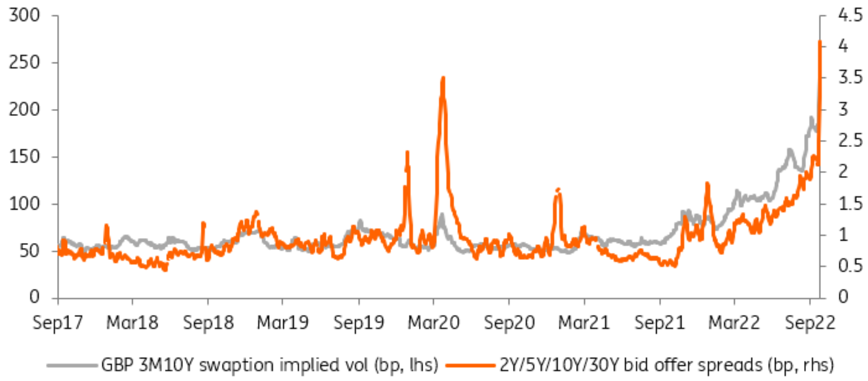
Investors are not viewing current levels as concessional

Either way this shows that long end yields are being re-priced, albeit in an erratic fashion. From a UK perspective there is the more sinister specter of a full-blown Gilt market crisis in the works. So far UK CDS (insurance on default) has held in, now approaching 50bp (5yr). That's double what it was. The odds are that it doubles again. Triple digit makes more sense. Italy is at 175bp as a guide. The US is at just under 30bp.

The words "Gilt" and Sterling" were originated as a signal of quality and strength. That's far from the case currently as we face into a period of real vulnerability.

Markets will take hope from Bank of England (BoE) chief economist Huw Pill yesterday saying it wouldn't sell gilts into a dysfunctional market, making reference to the Bank's plan to accelerate Quantitative Tightening (QT) with outright gilt sales next month. Stopping sales is a step in the right direction, we think the BoE should shelve QT altogether as it adds fire to the already distressed gilt trading conditions.

Gilt liquidity appears worse than dysfunctional - it is distressed and the BoE should stop QT



Source: Refinitiv, ING

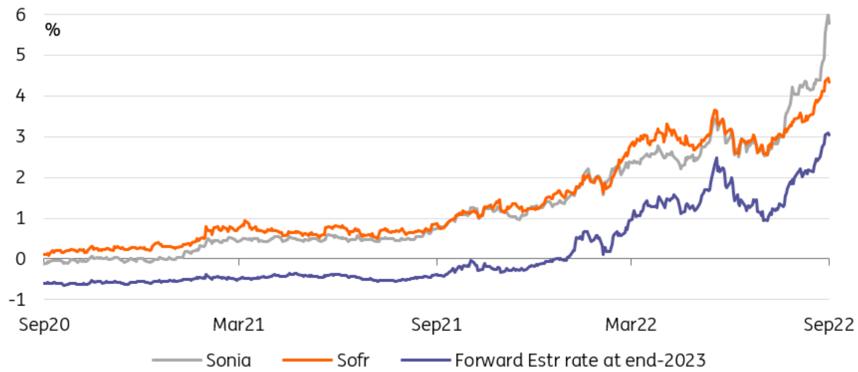
Markets think the ECB is on autopilot

EUR rates have mostly followed in their GBP peers' footsteps in recent days, and rightly so, but the ECB has been making a lot of hawkish noises that, in themselves, would have justified the move higher. To recap, the ECB's communication increasingly sounds like that of the Fed. Officials now admit the possibility of a recession, and that it would neither be sufficient to bring down inflation on its own, nor deter the ECB from its tightening mission. The conclusion in financial markets is that the ECB is on autopilot for another couple of meetings, or however long it takes to bring rates to neutral.

> *We do not blame investors from extrapolating further from an ECB that has so far followed in the Fed's footsteps*

In the current environment, most market participants would put that figure around 2% in the deposit rate, implying at least 125bp of hikes, which probably takes us to December. Of course, market pricing is for more hikes than that, they price the deposit rate rising above 3% by mid-2023, reflecting the view that policy will have to be brought to restrictive territory. This is where our view diverges from the markets', but we do not blame investors from extrapolating further from an ECB that has so far followed in the Fed's footsteps.

Cautionary tale: the jump in GBP swaps shows the market's fear of more fiscal support



Source: Refinitiv, ING

Not much appetite to fade the move, especially with fiscal concerns

The upshot for the bond market is that it will take time until it can contemplate the end of the adjustment higher in policy rates. At least until the December ECB meeting, and perhaps as late as the one on February 2023. This is a long time to wait and we doubt there will be much appetite to fade the sell off in rates until then. Of course, central banks are data-dependent and a sharp deterioration over the winter months will send rates lower in anticipation of an ECB pause, but investors have been bruised before. Even if the ECB stops at 2%, Bund yields trading only 20bp above that level, as they are currently, doesn't seem like an obvious place for the sell-off to stop, especially in light on very limited risk appetite.

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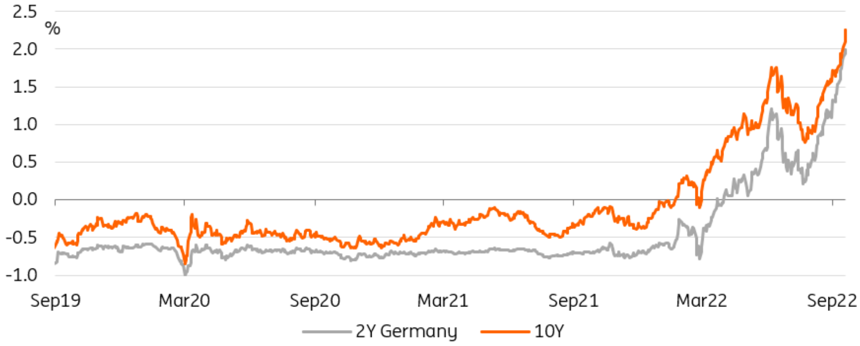
Recent ECB comments have made subtle but repeated warnings about fiscal policy. Even before the UK budget debacle, it seems one key concern for central bankers and markets alike is a scenario where too generous fiscal support pushed inflation up and forces them into more forceful hikes. This means fixed income markets should prove particularly sensitive around fiscal headlines.

If the ECB hikes to 2%, then bund yields can probably climb higher than that



Source: Refinitiv, ING

Today's events and market view

Italian confidence indicators and industrial sales are the main items on the macro agenda today. There will also be another long list of ECB speakers, including President Christine Lagarde, Peter Kazimir, Robert Holzmann, and Frank Elderson.

Once again Bank of England speakers will be closely monitored as they try to dampen expectations of emergency inter-meeting hikes. Jon Cunliffe and Swati Dhingra are due to speak. Chief Economist Huw Pill tried to walk a fine line yesterday by dampening expectations of an emergency hike, while at the same time highlighting that the government's fiscal support will meet a 'significant' policy response.

US data consists in mortgage applications, inventories, and pending home sales. This will complement a long list of Fed speakers, culminating with Chair Jerome Powell.

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