

Rates Spark: What volatility is telling us

Higher (forward-looking) implied volatility suggests rates have moved to a durably higher regime. This means investors' risk appetite will remain soft for the time being, and central banks should refrain from active asset sales. Fears of more lockdowns in China are bringing some much needed two-way risks to markets

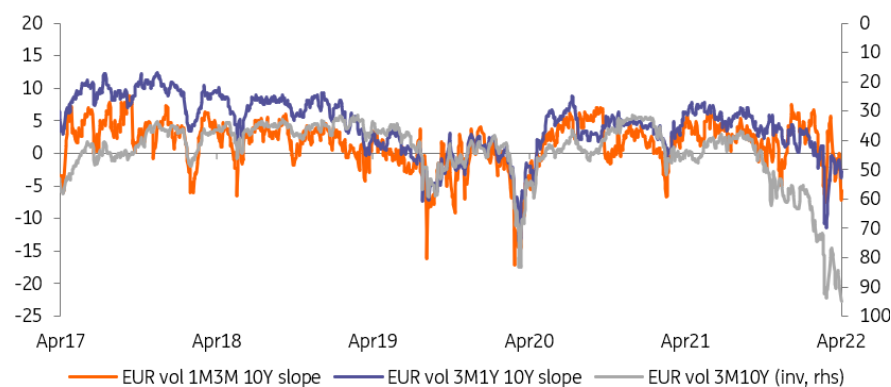


Injecting market volatility should pressure riskier bonds wider

Rates volatility suggests a durable new regime

Even with the market's legendary ability to process new information quickly, these past weeks have been a head-spinning experience with double-digit changes in yields across the curve a regular occurrence. It looked as if EUR rates were going to lag behind their US peers for a while but this assumption has also been proven wrong. Of course, markets are often guilty of using the present as their forecast for the future, but this gives credibility to the swaption market pricing comparable volatility over the next 1M, 3M and 1Y.

Swaptions indicate this isn't just a temporary spike



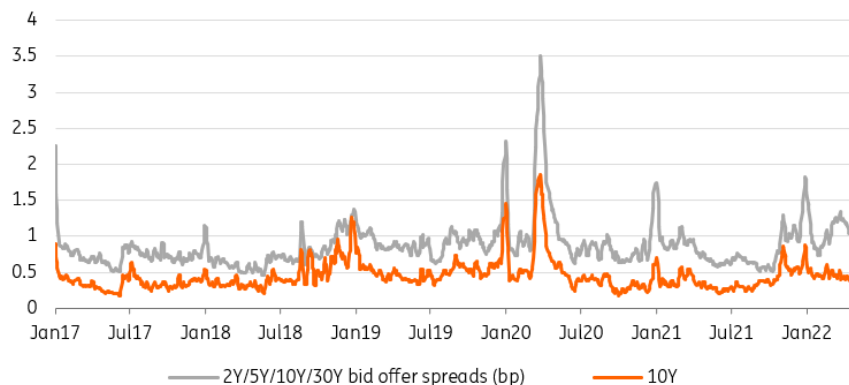
Investors risk appetite should remain limited in the coming months

Markets are still displaying the usual pattern of implied volatility being higher in the short term than in the medium term, but much less than in recent spikes (eg March 2020), and much less than the magnitude of the jump would imply. This suggests growing confidence that volatility is not spiking but moving to a higher regime. This ties in higher rates expectations, as volatility tends to be directional, dropping when rates approach the effective lower bound and rising rates move away from it. This also indicates that investors risk appetite should remain limited in the coming months, as higher risks typically mean higher returns are expected to make up for it.

Recession risk deserves a thought, and so does liquidity

Higher yields go some way towards compensating investors for the higher risk taken when buying bonds, but we doubt they will drop their aversion to interest rate exposure until either inflation expectations are under control, or until recession risk rises above 50%. We have been warning that the market's single-minded focus on inflation missed the looming risks to growth. It seems the threat of more lockdowns in China has brought these worries to the fore. In time, this could sow the seeds of lower rates and thus volatility but, for now, markets continue to oscillate between two scenarios with radically different implications for interest rates. This means more double-digit swings in yields like the one bonds experienced yesterday.

Wide bid-offer spreads are another indicator of stressed market conditions

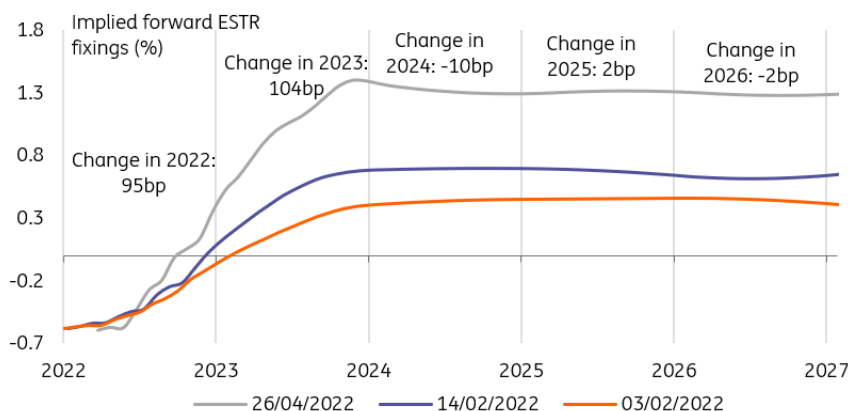


Source: Refinitiv, ING

High volatility can also be a symptom of worsening liquidity

High volatility can also be a symptom of worsening liquidity conditions in the bond market. This has implications for monetary policy. For instance, the Bank of England signalled that it would consider active gilt sales as soon as the Bank Rate reaches 1%, which should be the case as soon as next week. We argue that implied volatility and bid-offer spreads demonstrate that [the gilt market isn't ready to accommodate active central bank sales](#), although we fully expect them to be under consideration when liquidity conditions improve.

It would take a lot to impress an already hawkish EUR swap curve



Source: Refinitiv, ING

Today's events and market view

Pablo Hernandez de Co and Francois Villeroy make up today's list of ECB speakers. Amid

persistent reports that consensus is moving towards a first hike in Q3 2022, and at least one more this year, we think only a strong signal on the neutral rate could be construed as hawkish by the market. For reference, the Estr swap curve implies the deposit rates will reach 1.5% by end-2023, 200bp higher than currently.

Eurozone economic releases will be thin on the ground but the US will make up for it with durable good orders, consumer confidence, and new home sales. The market's sensitivity to bad economic news has increased noticeably so these could allow bonds to hold on to some of yesterday's gains if they corroborate the growth slowdown thesis.

Supply will be made up of Italy selling inflation linked debt.

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