

# Rates Spark: When behind the curve becomes ahead of the curve

US and EUR rates and curve dynamics are diverging further. EUR front end repricing lower continues as the window of opportunity to deliver on hikes is closing more rapidly. Greater US resilience allows the Fed to keep its inflation focus for longer, though one key to extending late cycle dynamics will be tomorrow's jobs data.



Source: Shutterstock

## US and EUR policy and economic divergence increases

Recession fears dominate trading, but this is leading to different patterns in the Eurozone and the US. While US 2s10s curves are flattening the EUR curve is extending its steepening move. The two central banks are of course at different stages of their tightening cycle, explaining part of the policy divergence that is being priced at the front end. We have seen the 2Y USD EUR rates differential widening on the way up as policy tightening was priced in globally, but now that overall rates are on the retreat again we also see widening as the EUR front end leads the repricing lower.

## USD-EUR widening on the way up...and now on the way down



Source: Refinitiv, ING

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*The US economy, and in particular the labour market, is showing some resilience*

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But then there is also the notion that the US economy, and in particular the labour market, is showing some resilience. The Eurozone is likely to suffer more from the upcoming downturn, also given the heavy reliance of Eurozone economies on increasingly uncertain imports of Russian gas. Against that backdrop the Fed's hawkish posturing and keen inflation focus as confirmed by yesterday's FOMC minutes is seen as more credible, even after having already raised rates by 150bp in total. Barring a larger disappointment in the US jobs data this Friday, another 75bp hike in July from the Fed looks likely. This contrasts with the Eurozone, where the window for the ECB to even complete a meaningful tightening cycle is seen as closing.

### ECB front end repricing may have further to run

In the Eurozone the repricing of rate hike expectations continues to push front end rates lower. With the unusually explicit guidance provided at the June ECB meeting for a 25bp hike in July followed by another hike in September – potentially 50bp if the inflation outlook were not to improve – the repricing relates mainly to expectations that had built for late 2022 and 2023. The ECB's policy rate is still seen around 130bp higher by the end of this year, and close to 200bp higher by end 2023, but that is now already more than 70bp and 120bp, respectively, lower versus the peak in mid-June.

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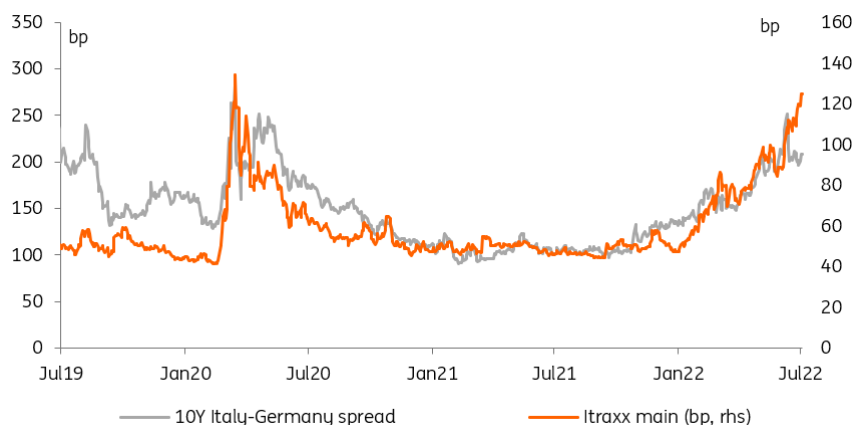
*The bull-steepening tendency of the EUR curve should persist*

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The bull-steepening tendency of the EUR curve should persist for now - not least as we see further room for adjustment given our economist's view of only 100bp worth of hikes delivered in total. The dynamics might be challenged if the ECB inflation hawks were to force through a more

frontloaded tightening before the window of opportunity closes. That could also prove more detrimental to risk sentiment with corresponding safe haven flow at the back end. In that respect the ECB minutes of the June meeting released today may offer some clues, also as to whether there is some wriggle room left for a 50bp hike already this month. The market is still attaching a small probability to that outcome. But usually the ECB minutes prove less of a market-moving event than, for instance, the Fed's meeting minutes which are more directly used to steer policy expectations.

## Italian spreads diverge further from other measures of risk



Source: Refinitiv, ING

Market participants will also scan the ECB minutes for any new information around the upcoming, and much talked about, anti-fragmentation tool. We have our doubts that the ECB will be in a position or even willing to already divulge more details, especially on the important aspect of the potential purchase volumes backing this new tool.

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*ECB is not yet under much pressure to provide details on its spread tool*

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As much as the market craves those details, the ECB currently does not appear under much pressure provide them. The key 10Y Italy/Bund spread is still trading below 200bp, and has been diverging further from other credit and volatility risk measures. It has thus also braved recent headlines about the tensions within the Italian coalition government after the split up of the participating 5 Star Movement. Whether this state of play in spreads can be maintained when the ECB fails to provide more details on the relevant aspects of its new tool, and heading into the less liquid summer trading period, remains to be seen.

### Today's events and market view

Yesterday's initial bull steepening in EUR rates was diluted as better than anticipated US data also pulled long-end EUR rates higher. The trading ranges of 17bp for the 10Y yields are emblematic for the current environment as data is scoured to gauge the depth of the

looming economic downturn, and tomorrow's US jobs report will deliver one important data point to gauge also the Fed's resolve.

The ECB minutes of the June meeting will certainly grab headlines, but usually they provide little new information. Data releases will be few, with only the US initial jobless claims of note and the usual ADP job report having been suspended for "retooling".

The French long end auction (including a new 10Y) as well as the Spanish auctions may see some post supply relief in the market which could temporarily dampen the steepening dynamic.

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