

Rates Spark: Widening communications gap

It is testament to the markets' state of mind when the curve bear-flattens despite dovish ECB comments. Further country inflation readings and the Fed's preferred inflation measure will add to the inflation obsession, all the while worries grow that central banks may end up doing too much (as 2y10y inversion illustrates).



Source: Shutterstock

Growing gap between market expectations and ECB communication

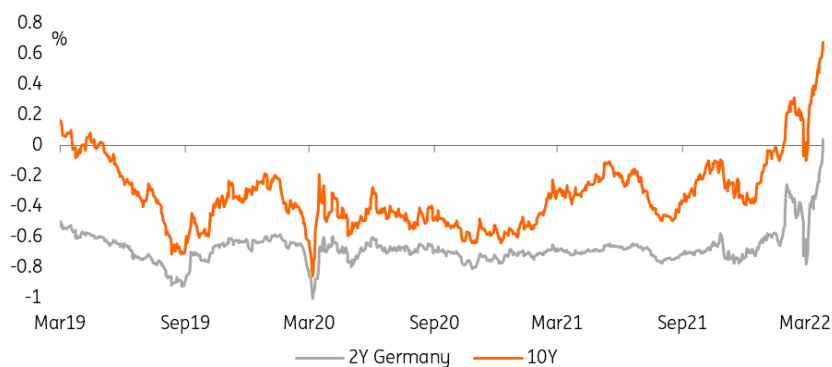
The reaction to the [upside surprises in country inflation readings](#) is testament to the market's state of mind, firmly focused on inflation and what central banks will do to fight it. Inflation certainly takes precedence also in the minds of the ECB, but the messaging coming from the central bank is more measured. Just yesterday ECB's Lagarde emphasized again that the normalization process would be gradual.

2y Schatz is now finding a footing in positive yield territory

The Bund curve bear-flattened despite Lagarde's dovish tones - the 2y Schatz is now finding a footing in positive yield territory while the 10Y was still testing the 0.7% level. Sure, there were hawkish ECB members on the wires as well, but in relation to what markets are pricing - discounting more than two hikes before year end - even they look dovish when calling for an end of asset purchases in 3Q and a first rate hike before year end.

Today we will get more Eurozone country inflation data from France and Italy ahead of tomorrow's flash estimate for the bloc. One might think that the market should be primed for further upside by now. But then, the inflation obsession is global and EUR rates are caught in that slipstream.

2Y German yields have turned positive



Source: Refinitiv, ING

US recession fears grow, 2y10y inverts amid increasingly aggressive Fed

As the Fed eyes its preferred inflation measure creep higher again today, the market is getting cold feet in view of a speedier hiking cycle. While rates have eased a bit off their highs it is the much watched 2Y-10Y UST curve which is on the verge of inverting after respective swap curves have dipped into inversion already at the start of the week.

The Fed itself seems less worried about 2Y-10Y inversion

It is that curve spread that is often regarded as precursor of a recession in the two to three years ahead, even though certainly not a sufficient condition. Indeed, the Fed itself seems less worried about a 2Y-10Y inversion, with Fed Chair Powell last week having pointed out that actually the first 18 months of the yield curve have the best predictive power of a recession.

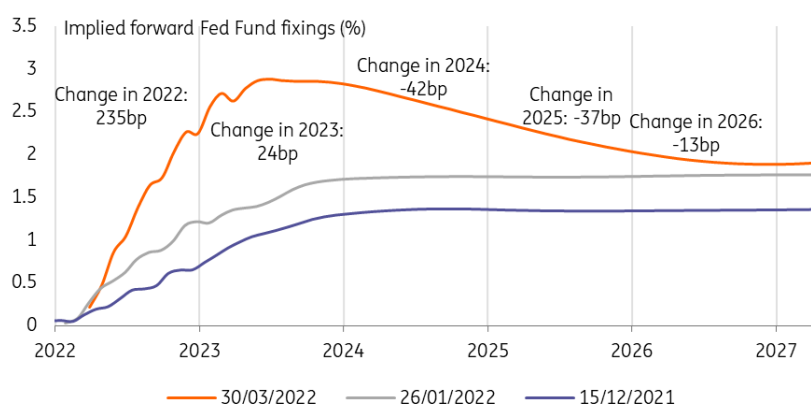
The 2Y 10Y curve signals recession as the Fed turns more aggressive



Source: Refinitiv, ING

Then again, that steep part of the front end curve, wouldn't it just be a reflection of the anticipated Fed overshoot that is now in the making? Coincidentally the peak of the distinctive hump on the 1m SOFR forwards strip is 18 months out, only beyond that do market forward rates start dropping off again.

Might the Fed be missing something when only looking at the first 18 months?



Source: Refinitiv, ING

Today's events and market view

After the upside surprises in the first country inflation data the Eurozone will see more country readings today ahead of tomorrow's flash estimate for the bloc. ECB's Lane and De Guindos will speak. We doubt additional dovish comments will be able to rein in markets, so they may just serve to underscore the widening gap between ECB rhetoric and market pricing for now.

US data could fan the hawkish sentiment with the release of the PCE inflation data, the Fed's preferred measure of price dynamics. The consensus sees the PCE deflator rising to

6.4% y/y and the core reading rising to 5.5% y/y. Also to watch are the personal income and spending data.

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