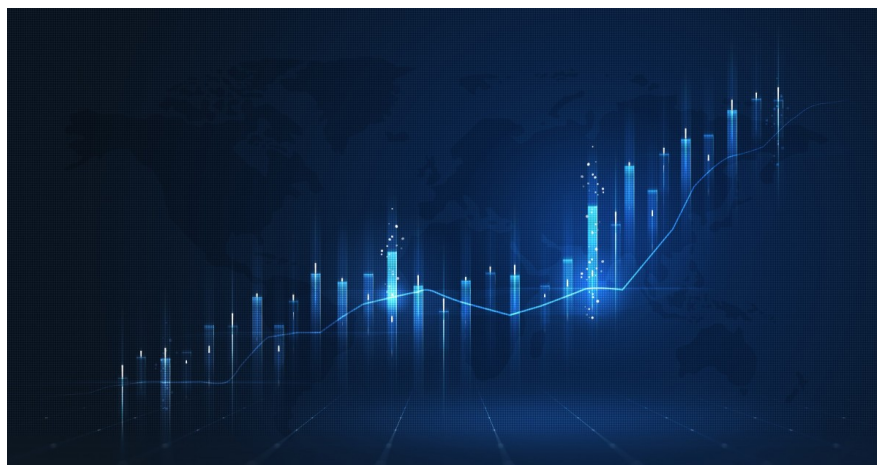


Rates Spark: The mood for risk is key ahead

Market rates are fretting about economies that are not lying down, at least not as much as had been feared. But they are also not on the starter blocks. More like they are taking on some welcome fluids. Yes we've been looking for market rates to test higher, now that we're here we think (misplaced) risk-on is the most likely route to even higher rates; else we dip



Market rates are loving this test higher momentum...

Front ends are hitting new extremes as the rate hike narrative from central banks has become more credible. The German 2yr popped above 3% on Friday for the first time since the Great Financial Crisis caused a crash lower in front-end rates a decade and a half ago. It held above yesterday, and looks quite comfortable with that 3% handle. The market appropriate measure of pan-eurozone rates is 6mth Euribor, which is now in the 3.25% area. And 10yr Euribor is also now at back above 3%. The 10yr was higher last year, up in the 3.3% area, but is being pulled back up again on the realisation that the front end still has some material upside risks.

It's a similar story on the US curve. Not only is a June hike of 25bp now fully priced (so we have 25bp priced for March, May and June), but a July 25bp hike is now being contemplated by the market. It's still discounted as being less likely than likely, but still, that's quite some change from where we were only a few weeks back when there was some debate as to whether the Fed would

hike in May, and there were even some doubts over March. The talk now is for a potential 50bp move, although we view this as being quite unlikely, and indeed unnecessary. The Fed needs a degree of underlying stability in order to be in a position to tighten, so upping the size of hikes here would be counter-productive.

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The other big change on the US front end has been the downsizing of the probability attached to interest rate cuts in late 2023. This is the other reason for the US 2yr to hit a new cycle high in recent days, as the 2yr is not just impacted by rate hike expectations, but also by what happens after the peak and over the subsequent period (over 2yrs, by definition). It's off the highs hit on Friday, but that 4.75% to 4.85% area is still only a smidgen below 5%, a level that the 2yr yield collapsed from in 2007 as the US banks began to have that feeling of impending doom that imploded as correlation to a failing housing market walloped all in its way.

The US 10yr has responded to heaping pressure to move higher in yield in the past few weeks, but still remains a tad anomalous in the sense that in the 3.9% area it's still some 150bp below the market projected peak in the Fed funds rate. This is double that should be expected, and indeed most of the time the 10yr hits that same peak as the front end does, only much sooner. Here the 10yr peaked at 4.25% (or 4.33% for a fleeting moment) back in October. Based off that it's telling us that the market discount for the funds rate won't be realised. We're tempted to agree in fact. A June hike should be the last one, and even that one is a stretch given the stresses we see in the financial economy.

... but risk is liable to be turned off ahead (albeit not likely this week)

The big question ahead is whether we can sensibly suggest that the US and eurozone economies are about to completely ignore the cumulative effect of rate hikes delivered. Remember these rate hikes have been quite aggressive, and quick, and they are not yet complete. At a certain point, economies will really creak. They began to last year. They've popped over the turn of the year. But that's far more likely to be a false dawn than the beginning of a trend.

Yesterday's US durable order numbers confirmed a 3mth downtrend, and the housing data confirmed an angst environment there. We may well get data that points to pops in both the US and eurozone economies, but the bigger picture is still not great. And again, central banks are still tightening.

The day ahead won't be pivotal in terms of key data releases. Rather we'll likely take our cue from the appetite for risk – stay risk-on, market rates are pressured up. Come off, and they can come down. We think market rates should be calming here after their hectic ride higher. But the mood is in fact to go the other way; risk-on and tempting market rates to dare to go higher.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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