Rates Spark: Yields have reached a sticky spot

Euro rates' failure to make new lows shows that policy normalisation is far from forgotten, it also brings bad memories of deleveraging in 2020. Granted, real rates continue to drop and a lack of clarity from the ECB would probably allow dovish pricing to be maintained for a while. Medium term, yields will struggle to remain below 0% in our view.

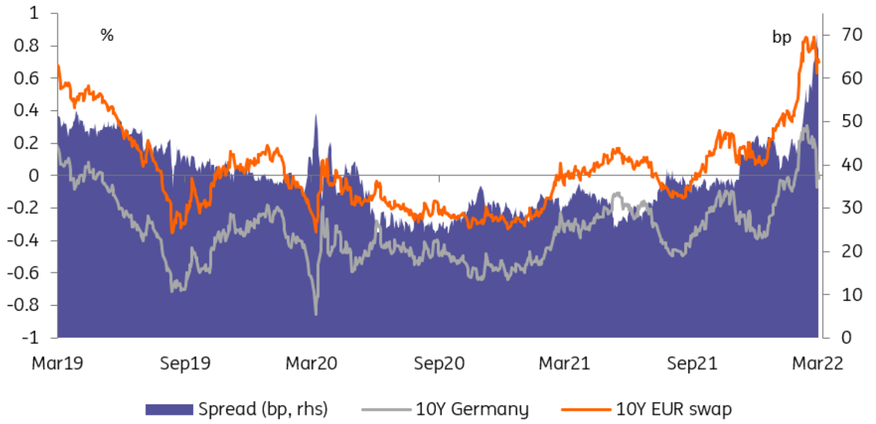
Dovish confirmation bias can continue for a while

Financial markets are dancing to the tune of Oil, which is in turn dancing to the tune of geopolitics. Overnight, Russia threatened to cut gas export if oil sanctions are implemented, while the EU is set to announce plans to reduce its dependence on Russian gas. For euro rates, the negative impact on growth far outweighs the positive effect on inflation. There are no questions that the bar is high to call off monetary policy normalisation, but it is probably lower at the ECB than for other central banks.

Markets are currently trading with a clear dovish bias

Markets are currently trading with a clear dovish bias, visible not only in low long end rates, but also in the pause in peripheral spreads widening, and in the curve pricing out near-term hikes. That dovish bias may well survive this week's ECB meeting, as a lack of clear signals typically allows confirmation bias to kick in. With a longer timeframe in mind however, a mere delay of the ECB's tightening would make negative yields hard to justify in our view.

Without flight to safety, Bund yields would be comfortably above 0%



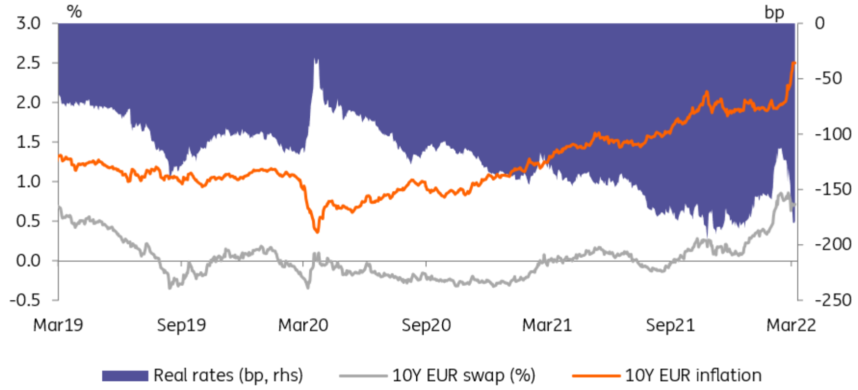
Source: Refinitiv, ING

For now, this is difficult to assess. Even the economic and financial repercussions of the existing sanctions are not well understood, let alone that of further escalation. This explains current Bund valuations. Even assuming no move in 10Y swap rates, a reversal of swap spreads to the levels prevailing in early February would put the 10Y Bund comfortably above 0%.

Flight to quality but deleveraging concerns mount

Rates appear to have reached a spot where further rallies (ie, drops in traded interest rates) becomes more difficult. This is testament to the resilience of the central bank normalisation narrative, but one should also point at real rates dipping to fresh lows thanks to the continued rise in inflation swaps. It is becoming abundantly clear that nominal and inflation swaps can decouple for long periods of time but the fall in real rates is another illustration of the dovish bias taken by euro markets.

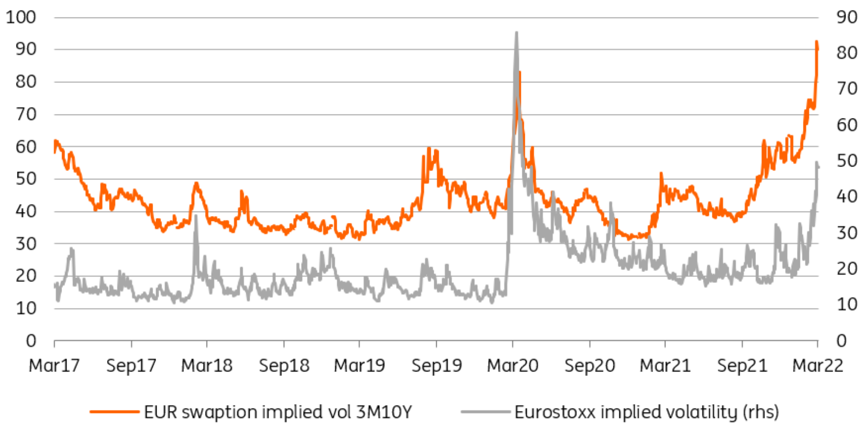
Lower real rates are another sign of investors' caution



Source: Refinitiv, ING

Another, more worrying, explanation for the reluctance of yields to make new lows even as risk assets continue their plunge, would be a worsening of market liquidity, even for assets suposedly easy to trade such as government bonds. As volatility rises across financial markets, the likelihood of widespread deleveraging increases. It is difficult to measures leverage across all financial markets but a key concern is a repeat of the indiscriminate selling that occured at the onset of the Covid19 pandemic, and which forced central banks into massive government bonds buying.

The rise in volatility brings fears of March 2020-style deleveraging



Source: Refinitiv, ING

Fiscal authorities have taken the lead in responding to the current crisis

A focus on the manyramificatios of the current risis has masked a further weakening of Europe's fiscal orthodoxy. Accounting tricks aimed at side-stepping Germany's debt brake explain why the figures floated to finance defence and industrial transformation do not translate into immediate financing needs. We're also waiting for a pan-European response to the cost-of-living crisis faced by customers. This should not divert attention from the fact that fiscal authorities have taken the lead in responding to the current crisis.

Today's events and market view

Today's Eurozone GDP print is its final release.

The Netherlands (7Y), Austria (3Y/10Y), and Germany (inflation-linked debt) make up today's supply slate. The UK will sell 30Y gilts.

The main releases out of the US include small business optimism, inventories, and trade. It might be too early for the full effect of higher energy prices on sentiment but this is clearly a key channel though which the current war in Ukraine feeds into lower growth.

Authors

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com