Article | 7 July 2022

3 calls for rates as the US tops out but the ECB has barely budged

It looks like the top for US market rates is in. The coming months may see some retrace higher, but the dominant impulse now is for rates to test lower. The fact that the ECB is only starting to hike as market rates peak is a sign of vulnerability. The tightening in financial conditions is all coming from market variables. Eventually, that also pulls rates lower

Fed Chair, Jerome Powell, faced US lawmakers last month to discuss the state of America's economy

1 US rates have likely seen a peak at 3.5%, look at the 5yr

A couple of weeks back, we made a call that the US 10yr yield had peaked after hitting the 3.5% area. The de-compression seen in the influential 5yr area of the curve drove that view, and since then there has been an outright richening in the 5yr area, as it effectively pulls yields lower. We expect this process to continue, likely inverting the 2/5yr segment of the curve.

A noted easing in inflation expectations has also been in play, a process that in fact began back in early May, but the move in the 5yr area has been the bigger signal that the top in US market rates is likely in. Data in the coming weeks and months could possibly push us back up towards the peak, but that is looking less likely, especially if the 5yr actually starts to trade rich to the curve (it is still moderately cheap).

Against that backdrop, the dominant theme for the US curve should be the 5yr continuing to outperform, with the curve shape now becoming quite nuanced (as a potential peak in the Fed funds rate in the fourth quarter would mean a dramatic re-steepening of the curve).

2 Amazingly, a peak in US rates and yet the ECB has hardly budged

The tightening in financial conditions in the eurozone has come primarily from market pressure, basically driven by rises in market yields, widening in sovereign spreads and a notable widening in corporate credit spreads. In the background, the European Central Bank, remarkably, has done very little in the way of tightening, apart from ending its quantitative easing programme (and even here the de-fragmentation threat has seen the ECB suggest that it could buy again as needed).

The eurozone 10yr swap rate peaked out at 2.65% in mid-June (as the US 10yr Treasury rate approached 3.5%), and coincided with the German 10yr yield hitting the 1.8% area. All of these are now lower by some 60bp. While the ECB will belatedly hike this month, it will be quite late to a party that has seen a global response to the threat of runaway inflation.

It feels to us that there remains some residual upward pressure on eurozone market rates, and even if frustrated by the direction of US rates, spreads between US and eurozone rates should narrow.

3 Further opportunities will appear

Many will have been caught off guard by the remarkable move lower in market rates in the past few weeks. Big swings in market rates typically correlate with heightened volatility, which can also mean that market rates could easily swing back up again. That suggests that there will be opportunities to get back into the bond market at better yield levels.

One thing is for sure though - the performance of bonds in 2022 has been the worst in modern times, and as such, it was always liable to come to an end at some point. We had anticipated that this would come in the third quarter, with a marked fall in market yields in the fourth quarter, but the starting phase has been accelerated to the end of the second quarter (June).

If 3.5% for US Treasuries does prove to be the turning point, there is a lot of room to move lower from the current level of 2.9%. The 2.5% area will be a logical target. For players that have missed the first lurch lower in yields, we anticipate there will be further opportunities (as yields can still re-trace towards prior highs on data releases), as is typical when volatility spikes. Being long the market and long carry is perhaps one way to fade through the remainder of 2022

Author

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

Disclaimer