

Rates: Why core market rates may rise

While risk assets have rallied off earlier lows, the US 10-year yield has not managed to budge much from the 2.5% area. However, the positive macro-story in the US, coupled with the fact that a Fed rate cut remains some way off, suggests the balance of risks are slowly swinging back in the direction of a test higher for market rates



Impressive inflows into risk assets

Inflows into risk assets have been impressive since the beginning of the year, in stark contrast to the dramatic selling of risk assets seen into end-2018. That risk asset selling coincided with an equally dramatic fall in the US 10yr yield from 3.25% to 2.5%. And while risk assets have since rallied off those lows, the US 10yr yield has not managed to budge much from the 2.5% area.

The US 10yr in the 2.5% area is remarkably steady given the strong inflow to risk assets

Some dodgy US economic data justified a medium-term Fed rate cut preference through Q1, in turn keeping market rates under wraps. But since then, US data has perked up. The fall in the 30yr mortgage rate that coincided with the fall in Treasury yields has also managed to stabilise angst that has been growing in the housing market. But still, the 10yr Treasury has held in the 2.5% area.

Market rates could be tested higher

The balance of risks ahead are slowly swinging in the direction of a test higher for market rates. The basic assumptions here are an ongoing inflows process to risk assets and a positive gloss on macro data. The off-setting pull lower in rates comes from the ongoing global slowdown narrative, weakness in Europe, and an ongoing stubbornness with respect to the regeneration of inflation generally.

The latter remains a massive issue in the determination of exceptionally low markets rates in Europe. But as we have noted before, low German rates are also reflective of a safe haven status against a backdrop where Italian government bonds have struggled with Italian political and macro concerns. Such concerns will linger right through to the end-May EU elections at the very least.

It is circular though, as the German 10yr yield at zero is also being pushed there by the US 10yr Treasury yield falling to the 2.5% area, to yield a 250bp Treasury/Bund spread. While the mean of this spread is around 50bp in the past 3 decades, rationalising a fair value spread in the 250bp area is not difficult based off a fed funds rate at 2.5% versus an ECB deposit rate of -40bp. Bund yields at zero partly reflect Treasuries at 2.5%.

Will US rates show the way for Europe?

The cleanest way for European rates to rise from here would be for US rates to show them the way, most likely being pushed higher by some firm labour market data. Right now the slowdown narrative is dominating the market discount. But this cannot continue if risk assets maintain the buying interest seen so far this year. The buying of risk assets by definition shows confidence in future growth and tolerable default risk.

European rates need US rates to do the heavy lifting first

One of the best performances so far this year has been from high yield corporates. This is a high beta sector and is expected to outperform in a market that is seeing spreads narrow. But is it also re-assuring for growth continuation, as it implies a benign implied market discount for recession. The rationale here is if a recession was imminent, corporate high yield would run scared on account of higher default risk.

The yield curve inversion narrative has also been curbed. Not only has the 10/30yr held on a respectable steepness, but the 2/10yr has re-steepened, and the inversion on the 2/5yr has almost disappeared. All this implies that a rate cut from the Fed is still quite a way off. If the Fed does anything in the coming year it is more likely to be a hike than a cut, and this risk is not being discounted. Market rates should begin to build that risk into current valuations, which implies some underlying upward pressure.

This article forms part of our Monthly Economic Update. See the full report [here](#)

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.