

The discount for angst deepens in rates markets

Curve inversion equals pain. The manifestation of that pain is typically a recession, and the antidote is (eventual) rate cuts. A lot of this is now being discounted. Banking sector pain has eased the inversion but only as more rate cuts are discounted. The market is looking through inflation risks and toward recessionary ones



Financial information ticker regarding Credit Suisse in Boston, USA - 16 Mar 2023

Source: Shutterstock

Markets now paying more attention to recession risks than to headline inflation

A journey lower for market rates is the structural view in the coming months. There are too many headwinds out there, and they culminate in a significant dampening effect on activity. The banking sector, in particular, has (significantly) tightened lending standards. And when lending standards tighten, economies typically respond in a negative fashion. For market rates, this effect is dominating the directional debate. The thinking is that the supply side may have created the inflation monster, but a big calming on the demand side can tame it in the coming few quarters.

The market sees inflation risk coming from higher energy prices

but also sees such risks as far lower as the economies go into recession

OPEC+'s production cuts add to upward pressure on inflation, particularly headline inflation. And underlying inflation can be affected as higher energy prices mean higher input prices across the board. The impact of the announcement was big. For example, the US 2yr inflation break-even rate shot up from 2.65% to 2.85%, an impactful 20bp rise. But that was practically reversed as soon as the PMI prints were reported in the low-to-mid-40s (recession levels). That's telling us that the market sees the inflation risk coming from higher energy prices, but also sees that such price risks are far lower if the economy goes into recession.

Eurozone break-even inflation up to almost 4% in coming year, with the ECB at 3.5%

A similar reaction function was seen on European inflation break-evens from the OPEC+ production cut announcement, as the 1yr breakeven rose from 3.8% to 3.95%. But the fallback was much more muted, with the 1yr break-even easing down to 3.9%. Break-even inflation rates further out the curve are lower, in the 2.5% area or a tad higher in the 7-10yr segment. In the US, break-evens are in the 2.3% area. So what we see is a more subdued long-term inflation discount longer term than what we would see over the next couple of years.

That in turn fits with the market discount for official rates. As it is, the liquid part of the Fed funds strip sees the funds rate at 3.5% by mid-2024, compared with just short of 5% currently (effective funds rate). So significant cuts are discounted. In the eurozone, the market essentially discounts that any hikes delivered from here on out are reversed by mid-2024, which also leaves us at around 3.5% for the European Central Bank's Refi rate. That combination implies an effective convergence between the Fed funds rate and the Refi rate, and by implication suggests more pain for the US economy than for the eurozone in 2023.

The new threat to the US economy is coming from the hidden pain in the regional banking sector. The eurozone version of this is far less prevalent. But the post-pandemic commercial real estate risk is one that needs to be negotiated on both sides of the Atlantic. The degree of inversion of yield curves tells a similar story – it's deeper in the US, and in fact was much deeper before the rate cut discount began to really build. Curve inversion equals pain. The manifestation of that pain is typically a recession, and the antidote to that is (eventual) rate cuts. A lot of this is now being discounted. Going forward, economies go into recession. The inflation discount eases. Rate cuts get delivered. Treasuries outperform Bunds. US market rates converge on 3% (or slightly below), and the Fed gets there eventually too, with the ECB much later.

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.