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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

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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.

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