

It smells like a peak in US market rates

When we hit 2% on the US 10yr we asked what next, and laid out a path to 3%. On hitting 3% we asked the same, and postulated the possibility of approaching 4%. A little over a week ago we hit 3.5%. Various signs suggest that could be the peak. That does not mean we can't get back there, as real rates are still too low and will rise. But if that was not it, we're not far off



Our expectation from here is to see some further upward pressure on market rates

Real rates should still rise, and might just take the 10yr Treasury yield back towards the previous high

We are at a point now where the peak seen at 3.5% in the 10yr US Treasury yield a little over a week ago is seeming more and more like a turning point. That does not mean we can't get back there. But it does mean that indicators are pointing to a scenario where a dramatic break above that level is looking less likely. Nothing is impossible, but here's the logic:

First, the 5yr has been quietly decompressing on the curve over the past few days. It is now trading at 8.5bp cheap to an interpolated line between the 2yr and the 10yr, and so still in line with a bond bear market. But it is far less cheap than it was (15bp a few weeks back), and it looks like it's on a journey of decompression. It's an early call, but we're paying close attention to the journey it looks to be on. As it decompresses it typically signals a change in the cycle. Now that could change, for

example should we see a surprisingly big inflation number and/or an outsized payrolls outcome in the coming weeks. But based on the developing discount, market expectations are pushing against that.

Second, the 10yr breakeven inflation rate has fallen to 2.5%. That was at 3% only a month or so ago. That's a big change in expectations. The real yield is still too low at 60bp. But even if that rises to the 1% area that we target, that would bring the 10yr Treasury yield back up to its previous high, without taking it out. For it to break above, inflation expectations would need to rise as well. It could happen of course. But then again that's not the journey that inflation expectations are currently on. In fact, inflation expectations could even fall, muting the impact of higher real yields.

As we've said countless times, turning points are difficult to predict, and we've identified the third quarter as when the turning point is likely to be. We still think we will have seen one by then, but we'd also note that it might just be from a level not too dissimilar from the 3.5% area seen on the 10yr a little over a week ago.

Watch the system risk. It's fine for now, but there are warning signs

At the same time, it's important to note that price action in the past few days has been remarkable. In fact, it was astonishing in the week or so before that when 20bp moves in both directions were occurring. The move from 3.5% down to 3.1% in the 10yr must be contextualised against that, in the sense that we could journey back up again should we enter a period of "risk-on" in the weeks ahead, or on upside data surprises. For the latter, we'd watch June payrolls on Friday week, and June CPI the following Thursday.

And a final point on the system. It's holding up fine here. Forget the elevation in the Ted spread (3mth bills spread to Libor), as that reflects a collapse in bills yields, in turn reflective of a repo market that is being strained to the downside (SOFR now at 6bp below the Fed funds floor as a record USD \$2.3tr goes into the Fed's reverse repo window at 1.55%). More importantly, banks are printing 3mth commercial paper at just 15bp over the risk-free rate. This is still quite tight, compared to a long-term average at around 25bp. Hence the system is holding up quite well.

But credit spreads are at stressed levels, signaling an elevation in default rates ahead of us, which is typical of recessionary periods. That in turn will result in a rise in system pressure, elevating bank funding rates relative to the risk-free rate. The market discount is no doubt factoring this, as is the Fed, which needs to get the tightening in before the system creaks. Another reason to suggest we're on the eve of a cycle change.

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 <http://www.ing.com>.