The war and rates – flashing Amber. Let's avoid Red

The war has shaped the rates discount for hikes. More of that, and rates could shape the path of the war. We identify many warnings, mostly at amber alert. A switch to red, and suddenly the kick-back domestically begins to dominate. Exposures to areas of vulnerability in turn can lead to a transferred vulnerability. Make it go away, and we can all exhale

The war in Iran has hit home dramatically through higher inflation expectations

There are many warning signs at amber, and prone to flash red

The environment is becoming quite tetchy. Flow data show that core bonds *are* being bought by investors. More biased towards shorter tenors. But still there is no big avalanche of selling that is driving yields higher. Rather, there has been a tendency for prices to be marked higher, and for bid-offers to become stretched. This is typically the way when the market becomes one way. The rise in inflation expectations has been a driver, often originating from the inflation swap market, which itself is not particularly liquid.

There is also a clear demand for US dollars in the marketplace. Key energy prices tend to be denominated in dollars, of course, and buyers need more dollars in order to pay up. And even though there is the optics of ample dollar liquidity in the guise of US$3tn of US bank reserves sitting at the Fed and some US$7tn invested in US money market funds, there is no easy access to these liquidity sources. The Fed's various liquidity provisions are, of course, there to provide US dollars where required, but players need to have access to these. More typically, international

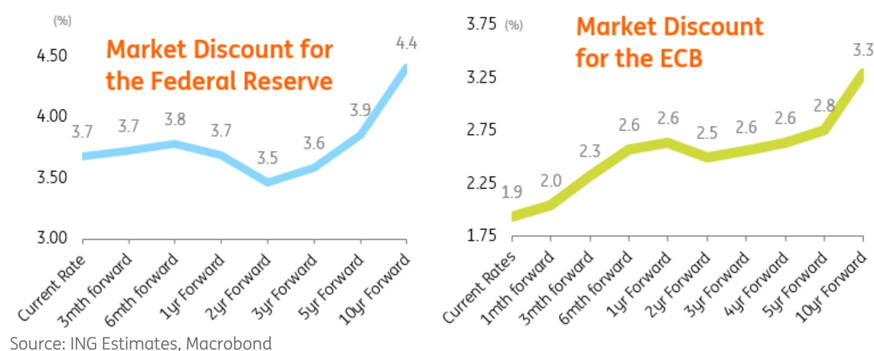
players have access to intermediaries rather than the source, and intermediaries themselves can have a tendency to hunker down.

Some of this is beginning to get reflected into a "basis premium" being attached to the US dollar leg on cross-currency swaps. This is deep in the weeds, but effectively is a measure of the willingness of (some) players to pay up to get access to US dollars. It's also being driven by the bid to the spot dollar itself. So far, it's not a big move, with the size of this premium still in single digits. But it *is* a sign of the beginnings of system stress. This could be calmed easily. But then again, it's at risk of spiralling if left to its own devices.

If we were to extrapolate another week (or weeks) ahead along the lines we've just seen, then many of these issues are prone to becoming really problematic. We should worry about tight lending standards getting that bit tighter, lower rated credit spreads getting priced that bit wider, and perceived dodgy or vulnerable exposures coming under more scrutiny.

The build of a rate-hike risk for both the Fed and the ECB

Uses the forward profiles from SOFR and ESTR respectively



Source: ING Estimates, Macrobond

The rates space is set up at a higher base rate anchor, and more pressure on long rates ahead

The war "over there" has hit home dramatically in the rates space, primarily through higher inflation expectations. As the conclusion to the war becomes ever more foggy, the high price of oil has become semi-structural in the market mindset. In consequence, the ratchet higher in inflation expectations looks far more than a passing fad. Hence, the evolving US market discount has become one of no-more-cuts, and if anything, its dominant hikes in the eurozone. Over the past year and a half, global bond markets have generally been used to interest rate cuts being the dominant impulse. That swing towards hike-alert marks a big shift in market mindset.

Just because rate hikes are discounted does not mean they will get delivered. Still, the dominant threat is that central banks get cajoled into delivering actual rate hikes. It's still a tad too early to assert that this will indeed happen, as the war-path could look quite different in the next few weeks. But things have not gone great in the past week or so, when it comes to the impact on global energy prices. Until that is materially negated by events, the rates market seems keen to double down on the rate hike risk.

Whether hikes get delivered or not, the build in rate hike worries is troubling for the bond market. Curves are getting clobbered on both ends. Higher inflation expectations are never good for longer

maturities, while shorter maturities are under immediate pressure from the elevation in the rate hike discount. In addition, the landing point in the 1yr and 2yr space for official rates is some 50bp higher than it was before the war. This pushes higher the initiation point of core curves, and the danger for longer tenors is its left curves looking a tad too flat. And if front-end rates don't budge lower, then back-end rates are forced to evolve higher.

Real yields have been rising too, which is a bit strange. It's contributing to higher nominal yields, especially in longer tenors. This could be construed as a beacon of hope, as higher real yields tend to correlate with reasonable economic activity. If things became really rotten for the economy, real yields would come tumbling back down. But then it's too late; we're likely in freefall. Until then, higher real yields are adding to the pain being felt on bond markets.

There is a point where the rates market doubles back and drives the path of war

Exposures to areas under market scrutiny tend to come under market scrutiny themselves, and we spiral on. This is not directed at private credit per se, but it is a case in point. It may be too simplistic to suggest that there is a direct link with the length of the war, but at the same time, it does feel that a positive delta on a war front would go a long way to removing the build of angst, and preventing it from becoming a material de-stabilising influence.

From a wider bond market perspective, the next leg to fall could be a material rise in long-dated yields. We've had a decent move to the upside so far. But not quite at the level that could prompt a Scott Bessent to advise President Trump that enough is enough, just as supposedly happened around the post 'Liberation Day' pause.

With that in mind, watch the 10yr swap spread. It's just below 50bp now. If that were to shoot to 60bp, it would spell enough trouble to ultimately shape the war path. Why? It's a measure of the de-rating of Treasuries. We need to steer clear of that. It's not just the negative perception, it's the added cost of funding US debt. Narrow swap spreads are the good look. Wide swap spreads are the opposite, and moreover help shape the basis for credit spreads and economy-wide funding costs in general.

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.