Rates Spark: Not as steep as we would like

When we're down and troubled, steeper curves offer a ray of hope. They by definition discount better times ahead. There has been steepening recently, and we think more is coming. However, we urge caution as the macro angst risks ratcheting up in the months ahead, stressing the reflation discount. Enjoy the steepening while it lasts.

US: A steeper curve is something to aspire to ...

We see the steeper curve as a good thing. It means that there is some optimism about the future, in the sense that a steeper curve produces higher forward rates, in turn a prediction of where rates can get to in the medium term. We see rates going nowhere in the near term. If central banks telegraph that, as they have, then that should cement clear knowledge for rates for the next few years.

And we can see this from the front ends of curve. They are flat out as far as 4 years at least. This ensures that the belly of curves in the 5yr area remain quite rich, as it is beyond 5yrs that curve begin to steepen out. Which makes sense, as one would hope that in 4/5yrs time that we are having a different conversation about the macro prognosis i.e. that it is considerably better than now.

... and why the back end fears average inflation targeting

Holders of long maturity paper have an issue if inflation is higher than expected. A fixed redemption amount and fixed coupons mean that inflation is a performance killer in real terms. The Fed's novel average inflation targetting maneouvre presents risks. It is not that the announcement can generate inflation. It is more that an average inflation targetting regime must imply that the central bank is less pre-emptive in nature that it would otherwise be. Long yields should be higher to reflect this.

This also gels with a steeper curve, as the front end is anchored. The thing is, it is unlikely that the curve steepens dramatically. There is simply too much macro angst out there. Moreover, the global economy is operating under a very large output gap that is in fact very deflationary. The fact that breakeven inflation has risen in recent months (from 50bp to 150bp in the 5yr) is not that helpful, as the bulk of this rise has come from lower real yields. That paints a poor picture for real growth ahead, and makes inflation generation tough to pull off.

> So yes some steepening is warranted, and even though the curve flattened yesterday that does not change the likely near term trend. But don't expect anything dramatic. In fact, any big steepening is likely to be quickly reverse in subsequent weeks should the macro story begin to creak. The activity data that we track is certainly pointing to some weaker numbers ahead.

ECB: slow QE buying, Schnable dashes hopes for early PEPP extension

Net ECB purchases in the final full week of August slowed to just €16bn across all programmes, with the €14bn bought via the pandemic emergency programme (PEPP) the second lowest weekly value on record. Going forward purchases should pick up again as the summer lull passes. According to ECB's Schnabel seasonalities as well as improved market conditions have played a role in getting purchases off their highs. As the economy was develeloping broadly along the ECB's baseline scenario she also saw no need to adjust the monetary policy stance, as such dashing hopes for an extention of PEPP as early as this month.

Today's events: EUR flash inflation and final PMIs, Green Bund

In the Eurozone the release of the flash inflation data for August will be in the spotlight. We will also get the final PMI manufacturing readings alongside the first reading for Spain and Italy. The US will see the realease of the ISM manufacturing, which should continue to tell a positive story.

In supply Germany taps linker lines (5y and 30y) for €0.5bn today, but attention will be on a possible announcement of its first green Bund syndicated sale which could then price tomorrow. Germany is slated to sell up to €6bn in the 10Y Green Bund which it had announced for September.

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