

Rates Spark: A big picture full of contradictions

The camera pans away from Georgia, briefly to Washington. And now to a panoramic vision, one that is so remarkable in its breath of issues, most of them riddled with angst. Deep negative real rates gel with this, and rising nominal rates will be constrained by it. There is deflation, and steeper curves, but prepare for no more than a gradual evolution here.



Source: Shutterstock

Overnight: FOMC minutes and bond sell-off

The minutes of the December FOMC were largely ignored by markets overnight due to a balanced message on potential policy steps. A small number of officials were open to buying bonds with a longer maturity as part of its QE programme and even to increase them should the economic situation worsen. Against that, there was mention of the Fed's tapering strategy. Clearly not a near term risk but the deflation trade is no doubt going to bring that debate forward. We would wager the attention will increasingly be on the Fed to remind markets of its dovish stance as yields keep rising, although this may wait until risk assets correct.

US remains a focus for division

The markets paid very little attention to the riotous behavior in Washington, sustaining the risk-on discount that has dominated since the clean sweep for the Democrats in Georgia began to be discounted. Now that we have clarity on the outcome, the next step is to assess what it means for bonds.

On the assumption of more stimulus there must by definition be more supply, and more supply usually means that bond prices are forced down to get it into the market. That plus the reflation theme are factors acting to push up yields. The counter pull comes from contemporaneous macro angst, and a degree of concern on potential tail outcomes from an unconstrained Biden administration.

The 10yr is holding above 1%, and it set to remain above 1% as a central view. The front end is also contained, with the 2yr still below 15bp. Given the tenor of the 2yr, there is clearly no Fed hike risk at all in play for the coming 18 months, at least. The curve can steepen further, but remember it is much more difficult for the curve to steepen from the back end.

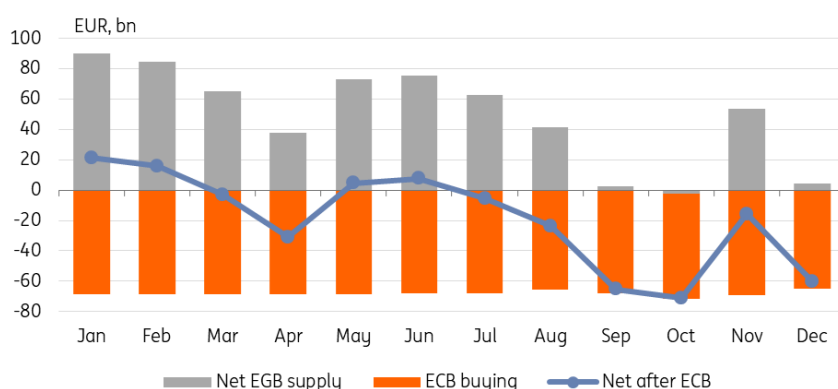
Except a slow evolution on levels and curve, rather than a revolution.

High European bond issuance is met by strong ECB buying

In the Eurozone, markets have been greeted by a flurry of new bond deals this week – from a new 15Y Italian bond to new 10Y lines from Ireland and Slovenia. EIB and KfW were also prominent in the market and the EFSF has already flagged a bond deal for next month.

All in all nothing unusual which is evidenced by the muted reaction of rates markets in terms of Eurozone intra-government bond spreads. Indeed we expect that syndicated deals should push gross issuance to over €130bn this month. And for the year as a whole we think gross issuance should stay close to €1.25tn, largely unchanged versus last year's already elevated total. In terms of net issuance, that is after factoring in bond redemptions, we expect a slight increase to €580bn from last year's €560bn.

Anticipated ECB buying should surpass net EGB issuance



Source: Debt agencies, ECB, ING

The ECB has ample ammunition to counter the flood of supply

However, this should not unnerve EUR rates markets. After its holiday break the ECB has already restarted its asset purchases. And following the decisions taken in December, the ECB has ample of ammunition to counter the flood of supply. By the end of this year we think the ECB may well have spent more than €800bn purchasing government bonds, more than the net supply stated above. For issuers that means no need to find new investors for their rising debts. And since a large part of the existing holder bases is either the official sector (including central banks) or heavily regulated (such as banks and the insurance sector) the selling would have to become quite substantial before the supply/demand balance starts to shift and upward pressure on rates builds from this direction.

Of course EUR rates were not spared from the US reflation story being boosted by the Democrat Senate take over. Near-term the domestic inflation readings could compound that effect. As [our economist wrote on German inflation](#), with base effects from VAT cut and energy fading in coming months, the headline rate is about to rise from here onward. It is a false dawn, however, as longer-term elevated unemployment, rising insolvencies and an appreciating EUR remain deflationary and ensure that the ECB will remain highly accommodative.

Today's events and market views

Today's Italian cabinet meeting will be the opportunity to judge whether concessions mulled by prime minister (PM) Conte can ease pressure within the current coalition. For background, Renzi has criticised the PM on a number of issues, some related to the use of EU recovery funds. Conte has since said the coalition will discuss a new outline for the use of the fund, and press reports earlier this week suggested he is ready to hand over more ministerial jobs to Renzi's party.

A compromise on both fronts would provide a catalyst of a further tightening of the 10Y Germany-Italy spread

A compromise on both fronts would provide a catalyst of a further tightening of the 10Y Germany-Italy spread towards our target of 90bp in Q3 of this year (from around 108bp currently). In case of protracted tensions, it is possible that Italy's performance is held back for longer but barring a collapse of the coalition and new elections, an unlikely scenario in our view, spread tightening should resume helped by supportive monetary and intra-EU fiscal policy.

In data eyes are on the preliminary Eurozone inflation reading which could signal that prices are on the mend again. In primary markets France is set to issue up to €11bn in 10Y to 30Y maturities and Spain will auction €6.75bn including a new 3Y bond.

Authors

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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