Rates Spark: A US 3yr hiccup, while European spreads do their own thing

The US 3yr auction tailed slightly on Tuesday. The excuse is it's rich compared to where it was. But it's actually not rich versus the market expectations for the funds rate. The 10yr auction is up next – a bigger deal. European government bond spreads tightened on the back of low summer supply and a central bank easing cycle, two factors that will fade

Supportive backdrop for EGB may start fading

Generally more benign macro data and now at least some 'certainty' around US-EU trade relations have provided the backdrop for 10y Bund yields to remain within an upwards trend that has been in place since mid-April. This backdrop also helped to now firm up views around the European Central Bank policy outlook. Markets are looking for only one more cut to be delivered within the next 12 months and along with improving sentiment rates volatility measures are sitting on cycle lows.

This environment has also been supportive of further spread tightening within the eurozone sovereign bond space. Not all have benefitted equally. The French 10y yield spread over Bunds is at

65bp, the tight end of the post-election range, but far from historically tight levels. This reflects ongoing political uncertainty and fiscal challenges in France which are also reflected in the latest set of PMI data. The latest French composite PMI remained in contraction territory where it has resided since last autumn. Italy has moved into expansionary territory – even if only modestly – since this year.

And it is indeed Italy that stands out, in particular, where the 10y spreads over German Bunds has dipped below 80bp, the tightest levels since early 2010 just before the sovereign debt crisis. The tightening leg was kicked off by positive rating dynamics, but clearly the declining volatility favouring carry trades and market technicals like slower supply over the summer (the debt agency cancelled the mid-August auctions) have helped to extend the rally.

The question remains how far markets can take the tightening. Some of the technical factors may be fading again soon and the ECB easing story as a supportive backdrop is also coming to an end.

US 3yr auction was not great. The 10yr is up next

Tuesday's US 3yr auction saw a half a basis point tail, which implies a moderate concession to secondary at auction. Not hugely surprising given the significant fall in front-end yields post Friday's payrolls report. The high yield was 3.67%. If the Fed gets the funds rate down to around 3%, that's still a 67bp pickup to 3%, which suggests that there could or should have been more interest, even in light of the recent rally.

The indirect bid (which tends to include central banks) was decent, at 54%. But that's down from 65% in the previous six auctions. And even though the direct bid was up, dealers had to take down almost 18% of the line, compared with below 15% in the past six months. Overall, not awful; but still, not a great auction.

The excuse is being used that the 3yr is rich compared to where it was a few days ago. But if this market really believes in rate cuts in the coming quarters, that 67bp concession to the floor being imputed for the funds rate offers value. The fact that it hiccupped slightly infers some doubt on the rate-cutting agenda, or at least the extent of it.

Wednesday sees the 10yr auction. It's a more important one, as its the benchmark reference point. It will ask the question as to comfort on taking down paper in the 4.2% area. That's 50bp above the 3yr yield, but that's not a steep curve. That's the risk as we head into this one. The outcome is not conclusive of anything, but is a real snapshot of sentiment at a particular level of yield.

Wednesday's events and market view

A relatively light calendar in terms of data and events. From Germany we'll receive factory orders and from Italy industrial production numbers. Retail sales for the eurozone aggregate could be of interest, but is generally considered second-tier data. From the US we only have MBA mortgage applications from last week.

In terms of supply we have Germany auctioning 13Y and 17Y Bunds for a total of €2.5bn and the US will auction 10Y Notes for $42bn.

Author

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer