Rates Spark: Hope for the best, Prepare for the worst

The Federal Reserve is not budging. For as long as the virus remains an unknown, a positive macro prognosis cannot be gleaned with any degree of certainty. The deflationary impact has been clear, and the rates discount remains troubled and reflective of this.

Front-end rates volatility has collapsed

Source: Bloomberg, ING

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FOMC placeholder

Our macro coverage of the FOMC outcome is here. Bottom line, the tone from the Federal Reserve remains one of concern. Its lending facilities have been extended to end-2020, plus repo and dollar swap lines have been extended to end-March 2021. The interesting twist here, however, is that the bulk of these facilities have in fact been falling in terms of usage in the past number of weeks. Some of them have barely been used at all. Others are at a plateau. None are on a material rise that would necessitate an extension. In that sense it costs the Fed very little to extend them.

The rates reaction has been one of looking to the downside. Large negative real rates remain a drag on the "V" shaped narrative. The 2yr is not budging, and is only tempted to ease lower. The 10yr is sitting comfortably at sub-60bp. And the 30yr at 1.25% is beginning to look like a bargain in a world of dampened down risk free rates, typically into deep negative territory.

Regardless of the equity market reaction, the bond market stance is more in line with a stressed
Main Street, and the Fed's actions and words are far more reflective of the angst factor than on a glossy forward discount.

Hope for the best but prepare for the worst, as Jay Powell noted.

And now a look at Eurozone data

The FOMC came and went and with it the last meaningful event risk before the summer break (GBP investors might disagree). It seems appropriate to remind our readers that we expect higher carry assets to perform well in quiet summer months, for which the stage is now set thanks to easy monetary policy and fiscal policy response.

Provided efforts to reach an agreement on a US fiscal stimulus package bear fruit, we even expect risk sentiment to be supported in the coming week. A roll-over of covid cases in some states would allow markets to 'look through' weak economic data caused by the second wave. This implies some re-steepening risk on the USD curve but this may only materialise after month-end.

In Europe, CPI and GDP readings to be published today and tomorrow are both backward-looking, but we wouldn't downplay the importance of the inflation gauge. This week again, the ECB's Stournaras stressed that whether the whole PEPP envelope is spent or not depends on the inflation outcome over the coming months. To be clear, it would take a strong outsized upward surprise for them to terminate the programme early but a soft print would be perceived as adding to the case for more stimulus.

Events today: EU inflation, US GDP

Today brings Spanish and German inflation prints, as well as a first look at Q2 German and US GDP.

Italian supply will resume after a 1-day hiatus, with the sale of 5Y and 10Y BTPs, and a 5Y linker.
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