

Rates Spark: Are we there yet?

Bond buying is adding a liquidity excess that is bullying market rates to extraordinary lows, practically into submission. It looks too much and should be unwound, but not just yet it seems. At least Chair Powell is not giving too much away so far.



The US may be motoring, but its not there yet

Chair Powell, before the House Finance Committee, is not for changing. Two things are still “a ways off”. One is “substantial further progress” and the other is the timing of the taper of bond purchases. On the first element, a key barometer is employment, which remains well below pre-pandemic levels. The second element depends on the first, and bottom line the Federal Reserve remains on an ultra-easing path, to help reach communities that have been hardest hit by the pandemic.

On the risks, Chair Powell acknowledges that inflation is significantly above 2%. But the key thing is where it lands in the coming 6-12 months, and for now the Fed has reasonable confidence that it will be far closer to 2% by the end of that timeframe. On housing, the explanation for the rapid rise in prices is changes in preferences and materials shortages, and not driven by reckless financing. Chair Powell is clearly distancing the Fed from any blame here, but with some justification.

The bond market couldn't care less, it seems. Maybe just listening super carefully, but could be

sleeping too. Having come through further confirmation of outbreaks in consumer and producer price inflation to the upside in the past 24 hours, and little appetite for a sub-2% 30yr bond auction, yields are practically unchanged, as if nothing has happened. Just like Chair Powell, this bond market too is not for changing.

From Chair Powell's testimony, there is no indication that the taper chat is any more elevated than it was at the mid-June FOMC meeting. There is a lot to be said in support of a much faster taper than anticipated. It needs to go from US\$120bn of bond buying per month to zero per month. From a purely technical perspective there should be no taper, and the Fed should just stop buying. But from the perspective of a "hardest hit community" focus, that won't happen.

So expect the liquidity excesses on front end rates and downward pressure on back end rates from this perspective to remain a dominating influence, especially if this bond market chooses to completely ignore where inflation prints.

ECB officials fail to inspire ahead of the meeting

The ECB's Schnabel had the final opportunity to manage expectations ahead of the 22 July ECB meeting. She did elaborate on the strategy review and also voiced the usual warnings that policies must not be tightened prematurely. She acknowledged that the economy was seeing a strong recovery, but that the medium-term inflation outlook remained subdued. But whether we will get a taste of the "new and untested instruments" flagged in the context of the new strategy to remedy that already next week is to be doubted.

For now the market adheres to its usual more-of-the-same and lower-for-longer conclusion. Inflation expectations as measured by inflation swaps have hardly budged if not slightly declined since the ECB announced its revised inflation target - the ECB faces a credibility problem and has so far failed to inspire markets following the strategy review. Next week will provide an opportunity to change that.

Bund yields did drop back towards -0.32%, but that is more a tracking of developments in US rates. At least the ECB seems to have managed to pull EUR rates out of the slipstream of rising US rates at the start of the week with the 10Y UST/Bund spread having come off its 160bp low seen last week.

Periphery debt spreads had been the main beneficiaries of Lagarde having indicated follow up action to the strategy review at the upcoming meeting. But also here the 10Y BTP/Bund tightening has stalled again at the 100bp level for now. It may be supply with Spain active today, but the market might just be waiting for new cues next week.

Today's events and market view

There is a raft of US data releases with the Empire State and Philly Fed indices, industrial production as well as the initial jobless claims. With supply disruptions and other effects adding noise, though, the market is unlikely to take direction from them. Also to watch is the second day of Powell's testimony to congress, but only the Q&A could bring about news, if anything. Powell already provided the most important cue yesterday, and with apparently no new urgency to the taper debate, the downward pressure on rates could dominate for now.

EUR rates will have to digest the remaining supply for the week, coming from France which sells up to €10.5bn in shorter dated bonds out to 7Y maturities plus €1.75bn in linkers, and Spain which sells up to €6bn across the 3Y to 15Y maturities.

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