Article | 9 February 2021

Rates Spark: Avoiding too much of a good thing

Reflation is set to remain the theme in rates markets after the debate about outsized fiscal stimulus risking once-in-a generation inflation pressures spills into the open. This plus supply should push US rates above key thresholds. EUR rates should follow. Important though that rates don't rise too aggressively; we doubt they will. But what if they did?

Source: Shutterstock

Overnight: fiscal details

In her European Parliament testimony, ECB president Christine Lagarde stressed the importance of maintaining monetary and fiscal support for the Eurozone economy. In that respect, Italian PM designate Mario Draghi's pledge to make a common Eurozone budget a priority would be helpful in the long-term.

Biden's plan to increase the federal minimum wage to $15 met resistance from the Congressional Budget Office. The president said over the weekend he expected difficulties in passing the measure. Also on the topic of fiscal stimulus: the house committee in charge of drafting the bill included an extension of unemployment insurance to end-August, and phased-out cheques for high income earners.

Overnight price action saw stocks retreat slightly from yesterday's highs while bond futures held on to their gains. The most notable move was probably the continued decline in the Dollar index, almost retracing its entire February rally.

Don't rock the boat too much, or else we face trouble

Market rates continue to test the upside. The next key impulse comes from US inflation, with the key numbers coming on Thursday. Inflation readings in recent months suggest the risk is for some more upside surprises.

The US 2yr breakeven inflation rate is now at 2.5%, and has only been rising in recent weeks. There is certainly an inflation story to unfold in the coming months. Two questions – how high, and for how long. Answers – likely a 3-handle, but could be 4, but we should then head back down to 2% (so not too long).

The risk ahead is that the bond market begins to run scared. We doubt it will, as we still see the curve structure as not bond bearish (5yr rich to the curve). But, there has been a build in volatility, and stranger things have happened.

That said, there would be a self correcting mechanism here. With the dividend yield on the S&P at 1.5% currently (and at 1.4% on the Russell 3000), any material rise in Treasury yields would bring into question equity market valuations – having an equity dividend yield at or below the Treasury one is not an equilibrium outcome.

In fact this is one that has foreshadowed big equity sell-offs in the past.

Slowly and carefully on the rise in US yields is the way to go here. Any rapid uplift in yields would see a quick return flight to safety, as risk assets face increasing risk of being pushed over the edge.

Pressure towards higher and steeper US curves persists

10Y US Treasury yields have approached, though not yet broken beyond, the 1.2% mark. But it could eventually happen already this week. Yesterday's pullback from the key threshold looks to be more technical in nature as the read-across from other market sectors such as equities and commodities suggests that there is no let up in economic optimism.

Over the weekend the debate over the impact of the outsized fiscal stimulus has spilled into the open. Treasury Secretary Yellen said the US$1.9tn fiscal stimulus would allow the US economy to return to full employment next year, but she has faced criticism from the likes of former Treasury Secretary Summers, warning that stimulus on such a scale risks inflation pressures "not seen in a generation". Tomorrow's US inflation prints could come to be interpreted as warning shots about accelerating price increases.

Our own economists see inflation rising 'well above 3%' in mid-2021, and this rise could prove longer lasting than the Fed is currently anticipating. Before the timing of the first hike in the cycle becomes topic, it should at least call into question the Fed's current reluctance to talk about tapering. In sum, we think the bear steepening trend in rates should remain intact and we could break above the 1%-1.2% range in 10Y US Treasuries quicker than we had anticipated.

EUR rates unlikely to evade US pull

At some point the speed of adjustment also in EUR rates could become a concern for the ECB and its pledge to preserve favourable financing conditions. Verbal intervention by central bank officials could become more frequent which should help widen the wedge between EUR and US rates, but not allow them to completely evade the steepening pressure. The same can be said of the PEPP asset purchases programme. The imedded flexibility allows the central bank to increase bond buying if it wants to cool volatility off.

For now the favourable market view of the political developments in Italy have helped keep 10Y Italian yields close to their all-time lows just shy of 0.5%, despite Bund yields now at -0.45% some 10bp off their recent January lows. For now that also means that there is little pressure to ramp up the weekly purchase volumes under the ECB's pandemic emergency asset programm. Net buying has averaged under €14bn per week since the start of the year, but the market will watch this space for any cues.

Today's events and market view

We looked for a break of 10Y US Treasury yields above the 1%-1.2% range only later in 1Q or in 2Q - the move over the past week was already faster than we had anticipated. Helped by long end supply we could top the upper end of the range already this week. Our forecast for 2Q is 1.5%, so there is plenty of upside.

The data calendars are light today, leaving the EUR rates to focus on supply. The Netherlands will sell a new 10Y benchmark bond for up to €6bn and Spain should proceed with the syndicated 50Y bond sale which it had mandated yesterday.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com