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Rates Spark: bear trap

There was noticeable departure from the Fed's dovish tone in its latest minutes. Lacklustre performance in stocks acted as a break on the US Treasuries sell-off. We think the move is unlikely to go into reverse unless the markets' macro assumptions are questioned. The ECB minutes could yield some insight on its FX reaction function.

Source: Shutterstock

The FOMC minutes - Leaves the back end unprotected from inflation risks ahead

The central point from the Fed minutes is no material change in tone – still dovish. At the same time the Fed has nodded approval for the December stimulus, and on the likely positives coming from vaccine effects on the economy in due course. The Fed has shown no panic on inflation as of yet, acknowledging the likelihood of a "spring jump", but also noting that the economy is far from where it needs to be. There is also no material evidence that the Fed is considering any near-term tapering, with conditions not likely to be met for some time, they suggest.

Not a whole lot for bonds to get excited about here. But at the margin there is a strong hint of a Fed that is indeed likely to take some inflation risk ahead, not seeing it as worrisome at this juncture, which reduces protection for long end rates and should allow them to test higher. The impact effect has seen the 2yr ease lower in yield, acknowledging the ongoing dovish signal from the Fed. Longer tenor rates are showing a tendency to edge higher. Back-end protection from the Federal Reserve is minimal at this juncture, even with a pop in inflation and a better economy.

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There was an interesting reference to front end liquidity conditions. The Fed noted that reserves were projected to rise rapidly through the summer, reflecting the ongoing QE programme, but also the Treasury choosing to spend chunks of the $1.7bn sitting on the Fed's balance sheet. Our note is that this will add liquidity to the system, placing downward pressure on money market rates. The Fed alludes to the rate on excess reserves (IOER) and repo as a means to ensuring that the effective funds rate remains above zero.

This, in fact, is code for a potential IOER rate hike. Such a move would be purely technical, but is added evidence of the need for more work to control the excess liquidity in the system.

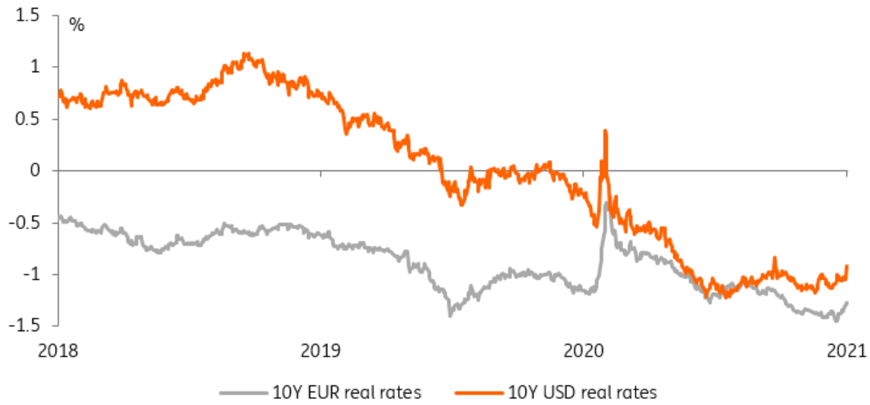
USD markets tap the breaks

The rebound in core (that definition is increasingly wide given the wafer-thin credit premia across markets) bonds yesterday has helped ascertain that stock markets can act as a stabiliser in the rise in USD interest rates. A lacklustre performance in risk assets apparently helped investors find the courage to buy into the rise in US Treasury yields. The wisdom of going against a generally-accepted macro trend for more than a day or two remains to be demonstrated but this would not be the first pullback this year. In January, 10Y retraced 13bp after its post-senate election spike

> *Newsflow is largely consistent with the reflation trade.*

Interestingly, this occurred as newsflow is largely consistent with the reflation trade, in particular the beat in US retail sales. We surmise that it is the pace of the adjustment higher in rates rather than the outright level that is cause for concern. After all, 1.30% yield in 10Y is not shocking in an economy about to overheat, as the Fed is trying to deliver. Comments from Fed officials of late have been consistent with this aim. The tone has generally been to underplay the risk of inflationary overshoot, and repeat the importance in maximising job growth.

Real rates are still plenty supportive for the economy...and risk assets



Source: Refinitiv, ING

ECB minutes: all about FX

With the focus rightly on the US as the main driver of the global reflation trade, opportunities for European rates to diverge are few and far between. To be clear, we do not entertain the hope that EUR rates could be insulated from the global reflation trend, only that they could lag their USD peers. As we wrote earlier the reflation trade in the Eurozone is already disconnected from fundamentals but it doesn't mean that EUR rates would fail to react to dovish comments in the minutes of the December meeting to be released today.

> *The reflation trade in the Eurozone is already disconnected from fundamentals*

Comments with the most market-moving potential would be on how the ECB is to react to a further rise in the EUR. Conflicting opinions have been voiced on the topic, which we would summarise as follows. Hawks would prefer a deposit rate cut, doves think asset purchases, and in particular a boost to PEPP, can do the trick. In light of the dovish tilt as the ECB of late, it may sound surprising that hawks have the upper hand on that debate. Another mention of rates cuts would contribute to steepen the EUR curve 10s30s, towards our 45bp aim.

Today's events and market view

Much of the action will be in primary markets, with France (front-end and linkers) and Spain (6Y/10Y/19Y) carrying out auctions. The duration impact should be limited in our view and we could even discern a preference for shorter duration bonds over the battered long-end.

Due to the dovish risks in the ECB minutes (see above) we see Euro bonds as better placed to maintain their gains than USD and GBP equivalents.

Italian PM designate Mario Draghi won a confidence vote in the senate yesterday, and faces a similar vote in the chamber of deputies today.

> *The main driver of USD rates should be whether risk assets can find a base*

In the US, the main event will be the publication of housing starts and jobless claims. The recent session have proven that market moves can take a life of their own when volatility rises, so we would not pin hopes of higher or lower rates on economic data. Instead, the main driver of USD rates should be whether risk assets can find a base. Overall, our default position is to call for what is most consistent with our macro view: higher rates.

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