Rates Spark: Bottom fishing

The relentless drop in bond yields raises the question of how low can they go. For 10Y Treasuries, we think 1%. For German bonds, we're probably closer to the bottom. The service sector is more liable to be impacted by Covid-19 cases. Look out for sentiment surveys today.

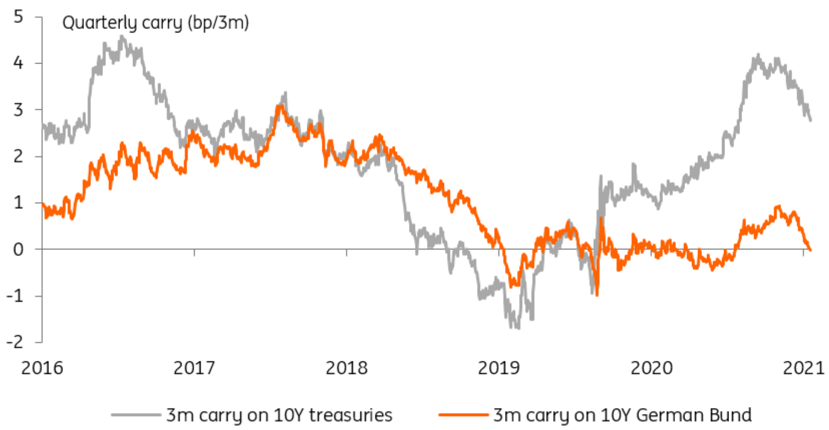
Source: Shutterstock

Where is the bottom for bond yields

The main catalyst for a change in current market dynamics would be a bumper non-farm payroll print on Friday. Save that, it seems that rates are on autopilot, trying to find the bottom of this year's trading range. For 10Y US Treasuries, we think this means a test of 1% in the near future. As we attribute that 'squeeze' higher in bond prices in large part to central bank buying in lower liquidity conditions, the best chance is for that floor to be tested this month.

For 10Y German Bunds, a logical floor would be where repo rates are pitched, potentially as low as -0.60% according to RepoFund, as even for leveraged buyers holding Bunds yielding less than that would entail negative carry. In practice, this threshold is psychological. It hasn't prevented all German government bonds with a maturity shorter than 9 years from trading below it. It is also notable that US rates are increasingly in the driving seat of this rates rally while their German counterparts have struggled to make new lows.

10Y Treasuries offer a clear carry pick-up to 10Y Bund



Source: Refinitiv, ING

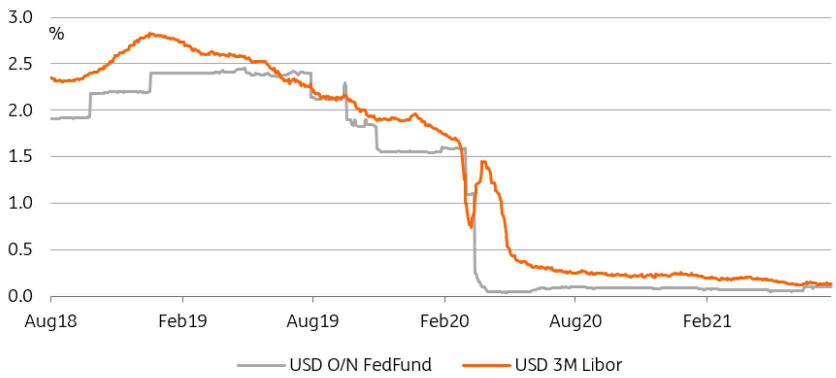
Investors looking for capital gains would also find the risk-reward of Treasuries more attractive

From a fundamental point of view, this could be justified by greater concern about the spread of Covid-19 cases as the current wave has shown signs of running out of steam in many parts of Europe. We think the reasons are more practical. US Treasuries still offer a generous carry (over 2.5bp per quarter) compared to their European peers (roughly 0bp for Germany). What's more, with the historical 'floor' for German rates approaching fast, investors looking for capital gains would find the risk-reward of Treasuries more attractive.

Front end pull also a magnetic factor

There is no sense at all that the Fed are anywhere near a rate hike given where we glean the front end of the Treasury curve. The 2yr at 17bp is certainly not entertaining a rate hike risk in the coming 18 months, as it breaks even against an implied flat floating future fed funds profile. A month ago it was 10bp higher at 27bp, at least beginning to give a nod to potential future hikes within its 2yr radar.

Low Libor fixings collapsing towards FedFund show no credit or term premia



Source: Refinitiv, ING

Pushing in the same direction, it's remarkable to see the effective funds rate at 10bp versus 3mth Libor in the 11bp to 12bp range, as it has been in recent weeks. Not just virtually no spread, but also no term. The level of 3mth Libor together with its tightness to the Fed funds rate is indicative of minimal systemic risk. In fact, 3mth Libor hit an historical low on Friday, at little under 2bp short of a single digit reading.

There is a front end pull in play here. One that manifests in the aforementioned positive carry attainable in funds longs. A spike in volatility can change this (watch the VIX), but for now this remains a pull factor for longer yields, as they get dragged lower.

Today's events and market view

As was the case for Monday's manufacturing indices, most of today's PMI/ISM services are second readings. The notable exceptions are Spain, Italy and the US. If there is a place we would expect Covid-19-related worries to show up, it is in these indices. Yet, the Spanish and Italian readings are expected to edge higher. The US ISM headline is forecast to remain stable but we would venture that most of the market attention will be on the employment component ahead of Friday's jobs report. Also on the topic of jobs, the ADP will release its payroll estimate, although our economics team has cast doubt on its predictive power.

Germany will sell 5Y debt.

The US Treasury will also publish its planned 3Q and 4Q auction calendar.

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

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