

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.



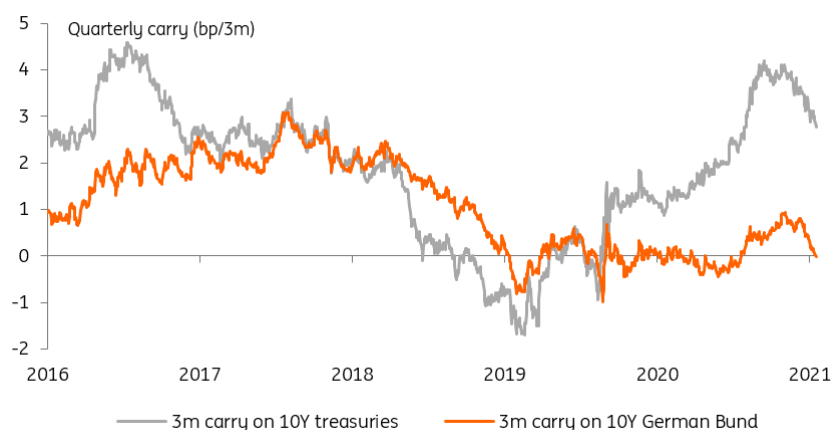
Source: Shutterstock

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

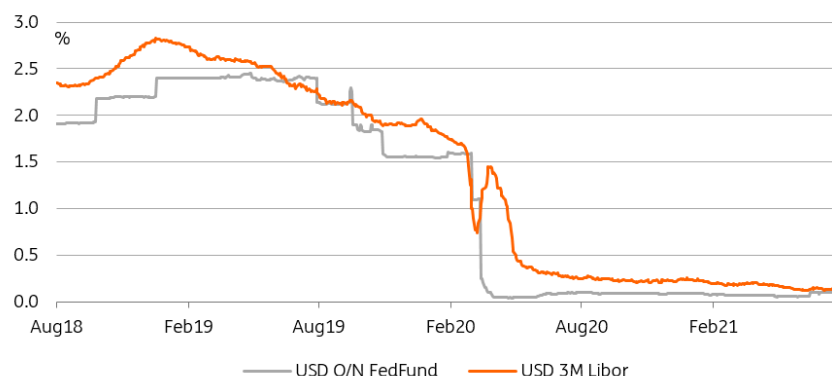
Investors looking for capital gains would also find the risk-reward of Treasuries more attractive

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.schroeder@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.