Rates Spark: Double dip doubts

Positive impulses continue to eke out of the US, while Europe faces a double-dip threat. The fact that the US curve is still steepening suggests that any European double-dip threat is not that infectious, just yet. PMIs could help long-end EUR find a base after a difficult week

The final 2020 United States presidential debate, Nashville, USA - 22 Oct 2020

Source: Shutterstock

Overnight: No debate fireworks, the Biden reflation trade is back on

US stimulus talks continued overnight after White House economic advisor Larry Kudlow poured cold water on hopes for a deal before the election yesterday.

The last US presidential debate failed to deliver either knock out blows or real policy insights. A slight edge for Joe Biden at the end of the debate was probably the least market-moving outcome in the near-term but this removes one obstacle for betting odds to converge with model estimates of a Biden victory (hovering around 90%).

This, in turn, should see further Biden reflation trade being priced in the USD curve, with wide spreads to EUR rates, and a steeper term structure.

The steeper US curve remains an important positive barometer

The contrast between the US and Europe continues to grow. In the US, the combination of data readings that have had a positive gloss on them together with the carrot of fiscal stimulus ahead is acting to maintain upward pressure on longer tenors market rates, and thus continues to steepen the curve. This steeper curve contains an important reflation discount, and for as long as it continues it points to a reasonable recovery prospect in the quarters ahead. Importantly, it does not discount a double-dip.

The double-dip story, however, has been raised as a live issue for Europe, especially in light of the unravelling of the Covid-19 crisis there. In the Eurozone, the curve itself does not have much information value, as the 2-year can conceptually go as low as it needs to go so that the curve does not actually invert. The level of rates is the more telling element. Here, there has been some recent nudges higher, but completely on account of pull from the US. Still, the 10-year Bund yield remains down in the dumps.

A combination of a steeper US curve plus a wider Treasury-Bund spread is a classic reflation combination. The big issue ahead is whether this is enough to dominate the near term angst that is hurting Europe. What would trump all of this would be a "vaccine moment" - a market opening where a pharma company announces a viable vaccine.

Regardless of how long or how many jabs are required, it would be a game-changer; in fact, it would be the cleanest route to 1% on the US 10-year (when we get there).

Calling time on a heavy week for EUR duration

After a heavy week for EUR duration, a decline in purchasing managers index, in particular services, might be just what the long-end needs to stabilise. For the first time since 13 October, the spread between 30-year USD and EUR swaps tightened yesterday, albeit not by much, in a sign that for once, the EUR anchor to global rates was happy to come along with the ride.

The blame for the rise in long-dated EUR rates lay squarely at the feet of supply in our view. Not only did the EU added a non-negligible amount of outstanding debt, but it also caused a number of opportunistic issuers to come out of the woodwork. A further rise in yields could be justified by the fear that more primary market activity gets squeezed before next week’s ECB meeting, but we think the proximity of month-end flow and steady drumbeat of ever-tighter covid restrictions will more than offset this.

Today’s Event: PMIs, Italy rating review

There isn’t much by way of potential market drivers on today’s calendar, except the October PMIs of course.

Of the data from France, Germany, the Eurozone, UK, and the US, we think market expectations will be for a notable dip in services sentiment. Keep in mind that PMIs are diffusion indices and that as such, it is the number of respondents affected by the decline rather than the depth of the decline that is reflected in the index. This is likely to skew the indices lower in case of mild but broad-based, restrictions on the economy.

Tonight, S&P reviews Italy's BBB rating which carries a negative outlook since 2018. We think the chances of a downgrade are small. Even if debt metrics have undoubtedly worsened. Continued ECB support and record-low yields are good enough reasons for the rating agency to avoid attracting some unfavourable attention.

A relief rally in case of no downgrade would be worth a few basis points of tightening on Monday morning, but we stick to our view that peripheral debt will underperform into the ECB meeting as chances of more easing being announced as soon as next week are slim.

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