

## Rates Spark: Closer to being Fed up

The Fed remains resolute - their job is not done. The bond market is listening; US yields rose into the FOMC, and came out re-testing lower. We see this as a temporary stall within a medium-term rise in market rates. But the Fed is doing enough to plant some seeds of doubt. We also note ongoing strong demand for fixed income. Remarkable in a bear market for bonds.



Federal Reserve

Source: Shutterstock

### The bond market is increasingly believing what it hears from the Fed, for now

Strong demand for fixed income had been the dominant rationale for market rates coming off the March highs.

However, market rates had been creeping higher in the days leading up to the FOMC outcome, not because anything material was expected, but more on account of a lack of inspiration to continue to test lower. Demand for fixed income can go so far, but when the macro data are persistently pointing in the other direction, it becomes difficult for the bond market to resist. The 5yr area of the curve had begun to re-cheapen too, another sign pointing to upside pressure for inflation.

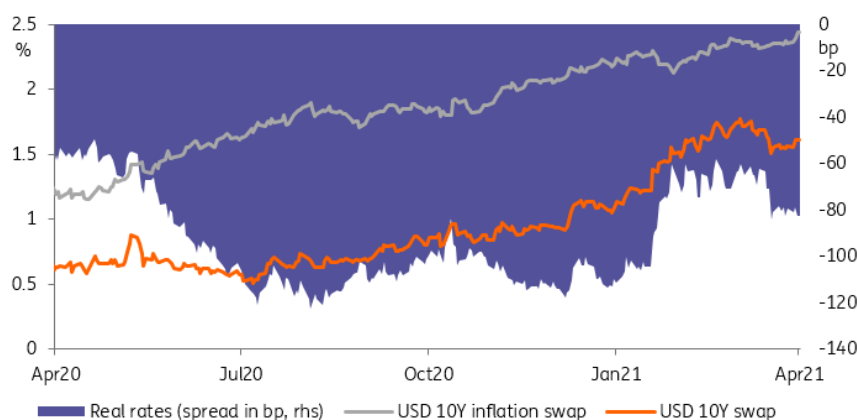
*The Fed is not budging from its super-easy policy. This still leaves the back end super-unprotected.*

While comments from the Fed's Powell were an acknowledgement that things have improved, it is also clear that the Fed is not for moving away from a super easy policy setting. This leaves the back end of the curve still quite unprotected from any unexpected inflation.

That said, The Fed remains confident that medium-term inflation will remain at 2%, and so far the market place is paying a decent amount of respect to this aspirational forecast. This is supporting the persistent ongoing demand for fixed income, including strong pension fund interest that continues to see its fixed income holdings increase. Ongoing Fed buying is another important contributor here.

The impact post Powell has been a further test lower in rates. We doubt this will be the aggregate outcome. Rather this is a downside test that is supported by a confident Fed. But it is still a downside test within a bigger picture uplift trajectory for market rates as we push through the coming months.

## USD swap rates compressed by bond demand, but inflation swaps power ahead



Source: Refinitiv, ING

## US Treasuries supported by strong demand and its not all from the Fed

Strong demand for fixed income remains thematic. This is quite remarkable given we are in the middle of one of the biggest bear markets for bonds on record.

Fed buying is one consistent component, but US pension funds too have upped their holdings of fixed income. Liabilities of such funds are discounted at a highly rated corporate bond, and the fall in rates in 2020 acted to push the PV of such liabilities up, dampening the positive total returns seen (for 2020).

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*Ever higher US pension fund holdings of fixed income remains an important undercurrent.*

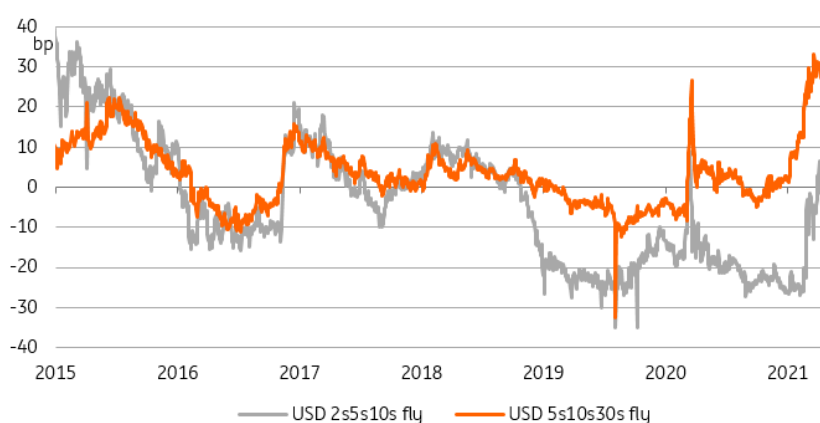
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At end 2020 there was a funded ratio of 88% (PV of liabilities above PV of assets). A high allocation to fixed income minimizes volatility in the funded ratio. The allocation was 42% in 2008. Last year it was 50% (up another percentage point from 2019). And it continues to rise.

In 2021, higher rates act to lower the PV of pension liabilities, which is good. Buying more fixed income at higher rates then locks in what pension funds have at better levels. Pension funds are not the only player in town of course, but it continues to prove a supportive factor for fixed income.

We are still looking for rates to break out to the upside, something to be aware of as a dampening factor.

## More than ever, USD swap butterflies point at rate upside



Source: Refinitiv, ING

## Eurozone rates are doing more of the upside testing these days, albeit still tentatively

Bund yields tested the upside yesterday, briefly sniffing above the -0.21% mark. Eventually we think higher rates should materialise as it will be increasingly difficult to turn a blind eye to the improving backdrop, especially in the US. As our economists point out, today's US 1Q GDP will be strong, with upside risks versus the consensus, and 2Q is likely to get even better. With US President Biden's ambitious fiscal plans out in the open, and the Fed meeting behind us we see less reason for rates to defy the upward pull.

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*The Fed meeting behind us, we see less reason for rates to defy the upward pull.*

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For Eurozone rates, that should imply further steepening along the curve. There are more nuances as the potential for front end rates to rise further might be capped by a further rise of the trade weighted EUR if it revives rate cut speculation. It appears ECB President Lagarde has started to put more emphasis on the topic again, yesterday noting that the central bank was closely watching the currency moves for its impact on the inflation outlook. That said, near term inflation readings are set to rise higher still, but mainly based on temporary factors as the ECB also laid out at last week's press conference. Ahead of tomorrow's preliminary Eurozone inflation data we will get country readings from Germany and Spain today

## Today's events and market view

If anything, data today should provide rates markets with more reason to embrace the upside in rate levels again. The main highlight is the US 1Q GDP advance release where our economists see good chances for an upside surprise versus the consensus of an annualised 6.7% QoQ. Other US data release to watch today is the weekly jobless claims figure.

In the Eurozone the preliminary inflation readings from Germany and Spain should point the way for the wider bloc, where data is published tomorrow. Headline inflation is set to rise mainly on the back of energy prices, so the focus should be more on what happens with core readings. Here our economists have pencilled in the possibility of an upward surprise.

In supply Italy will today tap 5Y and 10Y bonds plus floating rate notes for up to €8.5bn in total. This concludes Italian supply for the week which had seen a dual tranche 3Y/30Y USD deal and as such might allow for some reprieve in BTP/Bund spread.

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