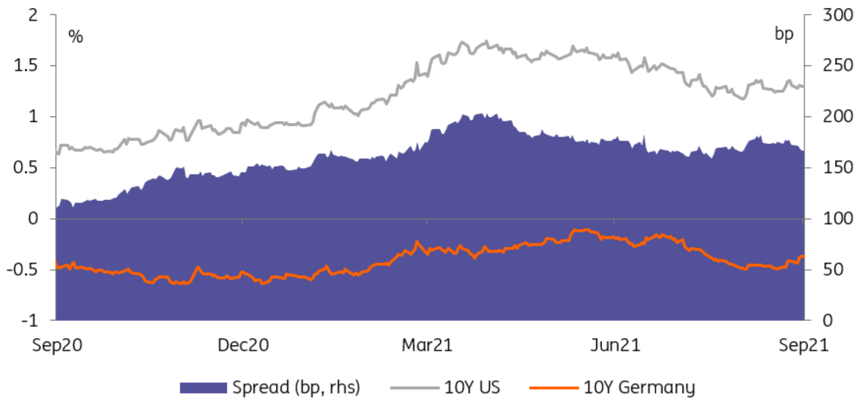
Rates Spark: Convergence or divergence

We doubt the drivers behind the narrowing of USD-EUR rates differential will persist: supply will swing the other way ahead, and overly hawkish ECB comments sow the seeds of a mini-tantrum. We're at a crossroads on many fronts. Direction usually comes from the US, but not always. Both the US and Euro rates likely need some synchronity if we are to test higher.

The USD-EUR convergence vs mini-tantrum

Rates differentials at the long-end of the USD and EUR curves have been narrowing significantly this week. We think this reflects timing issues rather than a real divergence of economic prospects. Firstly, Europe is slightly behind along the path to economic recovery. We suspect this goes some way toward explaining that the deterioration in US sentiment has largely spared the old continent, so far.

This week has seen a rare example of EUR rates catching up to USD



Source: Refinitiv, ING

The hawkish ECB tone run could morph into a mini tantrum

More to the point, an apparent divergence of tone between the Fed and the ECB has helped the convergence between USD and EUR rates. If Powell's cautious tone was lent additional credibility by a worsening in US economics data, the barrage of hawkish ECB comments this week came at the same time as a sizeable beat in Eurozone inflation. The hawkish ECB tone run could morph into a mini tantrum but, in this case, we think a further rise in EUR yields would pile pressure on the ECB to calm markets down, this doesn't seem like a sustainable driver for higher rates to us.

USD rates in the driving seat but a lot is in the price already

Regular readers also know that we are fond of putting market moves in the context of near-term supply and demand factors. This week's heavy EUR issuance, continuing today with long-end sales from France and Spain, has clearly put additional pressure on EUR rates. In the near-term, that pressure should abate once this morning's auctions are out of the way. On the other hand, US Treasuries have to deal with long-dated supply of their own next week. In short, supply will swing from pushing the USD-EUR rates differential tighter to pushing it wider next week.

The turn for the worse taken by US data is largely priced in

In short, we doubt that the current USD-EUR tightening can continue much longer, if driven mostly by a rise in EUR rates. A further drop in USD rates is a more realistic driver in our view. This is not impossible, given the turn for the worse taken by US data, but we think this is largely priced in. As is now widely flagged, Friday's jobs report will be key. Even in case of a large miss, we suspect the rally could be sold into, due to supply, and also as Powell's dovish tone has already largely benefitted US Treasuries.

Rate are already low, and should not really need to discount a (temporary) delta induced dip

> *A big question in the coming weeks is whether the rates market can take weaker data on the chin*

Directionwise, a big question in the coming weeks is whether the rates market can take weaker data on the chin, and not be too reactive to it. The thing is there is a slowdown in macro data in play ahead. A lot of it is delta variant impacted. So it should pass, and we should get to a proper re-opening. This is not likely until next year, probably by Q2 (or before). But the question is whether the rates market looks through the weak phase to that firmer uplift (which it should) or does it get bullied by data that tells us where we were in the rear view mirror.

The answer is far from conclusive at this juncture. We are of the opinion that there is a capacity to test higher in market rates even as data releases confirm some slowing in activity and indeed as confidence comes off prior highs. The US 10yr is pivotal here, and remains just about on the right side of the 1% to 1.5% rate, at above 1.25%. The ease below 1.3% yesterday does suggest vulnerability into Friday's payrolls report. But market rates have not caved just yet. Importantly, Eurozone core yields are showing a tendancy to come off recent lows and test the upside too.

Today’s events and market view

Much of the action this morning will be in sovereign supply. Spain (6Y to 12Y bonds) and France (10Y/13Y/30Y) will carry out auctions. Bonds stand a better chance to perform once supply is out of the way, especially as US macro expectations are in the process of being pared back.

European releases will be few and far between in the European morning save for European PPI. Based on the consensus forecast, there is no let-up in input prices, and thus no pause in inflation worries. Things will liven up in the afternoon with a host of US releases including jobless claims and factory orders and trade balance.

Raphael Bostic and Mary Daly make up today’s Fed speakers slate. We expect both to hold opposite views as to the timing of tapering so any departure from known positions could skew expectations ahead of tomorrow’s payrolls.

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