Article | 3 December 2020

Rates Spark: Credible threats and promises

In rates the diverging paths of the US and Europe will remain a theme for some time to come. One element is the EU's political struggles surrounding Brexit and the recovery fund, although the ECB remains the overriding factor driving rates. But even US optimism is prone to temporary setbacks.

Overnight: Mr T

Even if it is to dismiss the idea, two Fed officials were on the record talking about tapering its QE asset purchases late yesterday. Powell judged there is no hurry to, while Kaplan said the reduction in purchases should be dictated by economic conditions, hopefully later in 2021. A withdrawal of Fed support may not be an immediate concern for markets but it speaks to the pick-up in optimism, and to the potential USD rates have to diverge from their EUR equivalent.

Other newsflow overnight was mixed. China confirmed its status as a growth bright spot globally with a strong beat in the Caixin services PMI. At the other end of the spectrum, Germany and Italy extended social distancing measures until after Christmas. Restrictions were also imposed in parts of California. Perhaps in part due to those mixed messages, and in part as the market takes a breather after a sharp sell-off earlier this week, price action in rates markets was fairly muted overnight. Yields on 10Y US Treasuries still linger close to their highest level since the US election.

The eurozone's political struggles

On top of having to cope with containing the second virus wave, the EU has to two political struggles that are drawing close to crucial deadlines. Despite last ditch efforts the prospects for a Brexit deal have dimmed again of late, not that they were high to begin with.

On the other front, wrapping up a final agreement on the EU budget and the recovery fund, the positions of Hungary and Poland are unchanged. Their resolve to veto the project over the rule-of-law provisions appears to have hardened and next week's summit is often cited as the deadline for reaching an agreement, and to preserve the envisioned timeline for the distribution of financial aid. The EU has increased the pressure with talk about setting up a recovery fund among the remaining 25 member countries as a fallback to keep aid flowing. While the practicality of such an undertaking on short notice could be questioned, it should probably be seen more as an effort to produce a credible threat at this stage. In the end, self-interest also of Hungary an Poland, which now risk foregoing sizeable payouts from the EU, still puts an agreement within reach.

These unresolved issues should eventually help to contain the upside in in Bund yields. Throughout the entire political struggles it is more notable though, that sovereign bond spreads have continued to tighten. Yesterday the 10Y Italy/Germany spread has slipped below 115bp and we are now eying the tightest levels since early 2016. It underscores that the ECB and the promise of additional asset purchases remains the overriding factor keeping both yield levels and volatility in check.

US optimism, but not entirely without worries

There is a strong attraction towards the 1% handle in the 10Y US Treasury yield as optimism is further bolstered by bipartisan fiscal stimulus talks. As yields push past 0.95% and November highs are tested, the 10Y US Treasury/Bund spread has widened towards 147bp.

The diverging paths of the US and Europe will remain a theme for the time to come, but the US still has a rough patch to overcome. Today's data should come as a reminder with the ISM for the service sector, much affected by containment measures and benefitting from weaker USD to a lesser degree, could offer a more sobering read than the manufacturing gauge. Focus should also be on the employment component ahead of tomorrow's official jobs report, with the consensus for the change in non-farm payroll having crept lower to 486k. That said, today's jobless claims data should be the more timely indicator.

Today's events: Busy data, final French auctions

The data calendar has much to offer. In the US the focus is on the ISM non-manufacturing and the initial jobless claims for a mor timely read on the fallout stemming from stricter containment measures.

In the eurozone we will get final PMI data which also includes the first reading of Italian and Spanish services PMIs. Also interesting is whether retail sales have held up in October ahead of the November closures in some countries.

In supply France will hold its final auction for the year, selling up to €6.5bn in longer dated bonds.

The debt agency yesterday cancelled the remaining bills auctions for the year.

Authors

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com