

Rates Spark: The Fed builds while the ECB monitors

A more dovish Powell would help firm up the September cut expectations ahead of the CPI release due Thursday. Whereas in the US we see the rate-cutting narrative picking up momentum, in the eurozone the direction is less evident. The 10Y Bund yield is close to 2.5% again, an area it has been trading around since April



Treasuries poised should Thursday's CPI report play ball

Treasuries had their post presidential debate mini-tantrum, but have calmed since. The 10Y is back in the 4.25% to 4.30% area, and looking for an excuse to dip lower. The rationale for doing so can come from Thursday's CPI report for June. The May report had enough there for us to pivot from being bearish on Treasuries to positioning for a more definite rate-cutting tendency ahead. Our view having seen that report was that it was repeatable in June, and beyond. If that is the case, the rate cut discount for September can harden further.

We're now at an 80% probability for a 25bp cut, which is a decent enough discount. Chair Powell has an opportunity to impact that discount should he choose, but we suspect not. The build in that discount refers to the same data as he is looking at, and most of it has softened since the last FOMC meeting. What is remarkable is the low ebb to volatility and the risk-on backdrop. Typically

when everything looks rosy things go wrong, so we'll keep an eye on it.

There are auctions to get through in the coming days, 3's, 10's and 30's. The 10's and 30's in particular need to be watched. A heavy reception can frustrate efforts to get lower in yield, but we suspect we'd need to see a surprise upside to the CPI report on Thursday to really trouble Treasuries here. Typically the build of a rate cut discount and delivery of it is a time when being long is the safest bet.

Meanwhile, we also note latest data showing a fall in bank reserves to \$3.2tn. That's still elevated, but any tendency to break below \$3tn in the coming weeks would point to a tightening in liquidity conditions that can have ripple effects. We find this a bit strange as there is still some \$400bn going back to the Fed on the reverse repo facility. That should really fall first before reserves take up the slack, the rationale being that posting cash back at the Fed is a pre-reflection of excess liquidity; unless it can be explained away by inertia (players just keep doing what they have been doing, and just post at the Fed).

Eurozone not ready for full cutting cycle

Whereas in the US we see the rate-cutting narrative picking up momentum, in the eurozone the direction is less evident. The 10Y Bund yield is close to 2.5% again, a handle around which it has been trading since April. The data in the eurozone has simply been more mixed regarding the direction of the economy, with headline inflation coming down, services inflation and wage growth remaining stubborn, and labour markets showing few signs of deterioration.

We still think the next cut by the European Central Bank will be in September, but this does not have to signal a series of consecutive cuts. The June cut was a hawkish one and should also be seen separately from a full easing cycle. Markets are reluctant to price in two more cuts for this year and we too think more data is needed to support that. This also means that the front end of the curve can remain anchored for longer than in the US, thereby limiting the steepening potential of the 2s10s of Bunds in the near term.

French election outcome leads to more uncertainty

French spreads compressed a couple of basis points on the back of the election results, though it's too early to draw strong conclusions in our view. The path forward has only turned blurrier and with the left coming out stronger than expected the fiscal deficit is unlikely to take priority. Also the consequences for the EU as a whole is not clear-cut because both the left and right in France are known to boast anti-EU rhetoric. We would not be surprised if OAT spreads widen from here since the political system has little experience with the current state of play and thus the outlook is one of volatility.

Tuesday's events and market views

Key event to look forward to this Tuesday is Fed Chair Powell's semiannual monetary policy report to Congress, starting with testimony to the Senate Banking and Housing Committee. Usually the testimony is published ahead of the event, but Powell will still face a Q&A session. We think that he will still sound tentatively dovish as he did in recent comments, but we will watch out whether he acknowledges some of the more recent cooling in the labour market. There is not too much data to go by today with only the NFIB's small business optimism index out of the US worth noting. Out of the eurozone we have the ECB

speakers Panetta and Cipollone.

Primary markets will see the Netherlands tapping its 20Y green DSL for up to €2bn and Austria also reopening a 5Y green bond alongside a 20Y line for a total of €1.4bn. In the US the Treasury will sell a new 3Y note for US\$58bn.

Author

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@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.