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Rates Spark: exporting the reflation trade

Reflation is no longer a US-specific dynamic. Each with their own rationale, EUR and GBP rates have joined the party. In both cases, central banks are playing a role. This narrative has legs in our view and we've reached the point where market moves can feed on themselves

Source: Shutterstock

Overnight: US Treasuries' rare rebound

USD markets reopened after an extended weekend to a fairly light trading session and newsflow. Against a background of broadening economic optimism, the threat of China banning rare earth materials weighed on the mood and allowed bond futures to rebound. Still, the 10Y benchmark went within a whisker of our weekly target of 1.25% at some point in the Asian session.

As reflation hopes broaden in Europe (see next sections), the focus could still shift to one of the key reasons we expect economic divergence with the US this year: fiscal policy. In the UK, the institute for fiscal studies suggested £60bn of tax increases are necessary to pay for measures taken during the pandemic. In the EU, the Eurogroup said it will decide on a common budget stance by the summer.

Higher EUR rates are nothing to be scared of

It is no longer enough to say that the main theme in developed rates markets is the reflation trade that originated in the US on the combined impact of aggressive monetary and fiscal policy. The most interesting development is how quickly this narrative is spreading to other markets with scant reasons for believing in a step change in inflation dynamics any time soon.

There is a long way for rates to return to their pre-Covid levels

No matter. Financial markets are heavily correlated and if USD duration is taking a drubbing, it is likely to affect investors in other locations. Then again, we think the move has caught many by surprise, and was fuelled by some policymakers' comments of late, not least the Bundesbank's Jens Weidman warning of policy tightening when inflation recovers. In the Eurozone specifically, there is a long way for rates to return to their pre-Covid levels, but they have no business normalising without the ECB's ascent.

...at least for the ECB

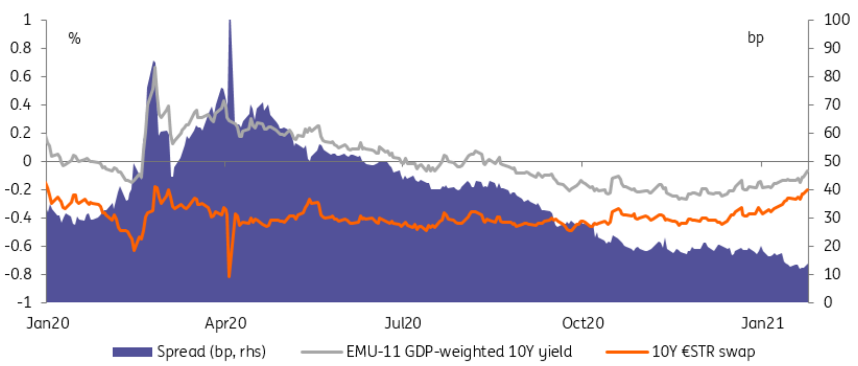
Data published by the central bank about purchases settled last week do not suggest any form of alarm, and perhaps there is no reason to be alarmed. Granted, outright EUR rates are on track to rise to the levels prevailing last spring (we warned last week that 10Y EUR swap rates could test 0% in the first half of 2021 before going back down), but one of the indicators flagged by the ECB is still signalling easy financial conditions.

0% in 10Y EUR swap rates

could be tested in 1H 2021, before going back down by year end

When taken as a spread to OIS swaps, the GDP-weighted average yield on Eurozone government bonds is actually signalling easier financial conditions for governments. The ECB is in the middle of a discussion to make its definition of favourable financial conditions more holistic but, at least, the above does not provide a justification for higher asset purchases. This indicator is an interesting one in that it is more flexible than outright yield targets. As long as the ECB judges that rises in EUR swap rates are justified by a better economic outlook, it has no reason to lean against it.

Government yields have risen, but less than swap rates



Source: Refinitiv, ING

UK top of the class

The epicenter of the rise in developed market rates in recent weeks has not been the US but the UK. We are not suggesting that GBP rates are the cause for reflation hopes and fears but the magnitude of the move (10Y Gilts underperformed US Treasuries by almost 10bp this year) is significant. To be sure, the rapid decline in Covid case counts in the UK, coupled with a top of the class vaccine rollout programme have boosted optimism.

> *The risk of higher interest rates is something worth taking into account*

More significant perhaps has been the change in Bank of England (BOE) communication. After extending its QE asset purchase programme as recently as November, the central bank has both quashed hopes of further rate cuts and kick started a debate on policy normalisation strategy, no less. To be sure, any monetary tightening remains a long way away, but there is a distinct sense that the risk of higher interest rates is something worth taking into account.

Today's events and market view

Today's economic calendar offers an early peek at February sentiment indicators. In the eurozone, the Zew survey of investors will make the headlines. It will be interesting to see if economic expectations have kept pace with market moves. We suspect they have. In the US, the more localised empire manufacturing survey will be the main focus.

USD markets were closed yesterday and will have to catch up to the rise in EUR and GBP rates yesterday. Beyond this, we think that by now the reflation trade is as much a market story as an economic one. Indeed, the speed of the adjustment higher in rates risks feeding on itself and triggering rates portfolio rebalancing. One example is gamma hedging to adjust for the declining duration of rates portfolios as rates rise. Another is that investors could be justified in re-sizing their portfolios as the previously held assumptions about rates volatility are questioned.

Authors

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

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

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