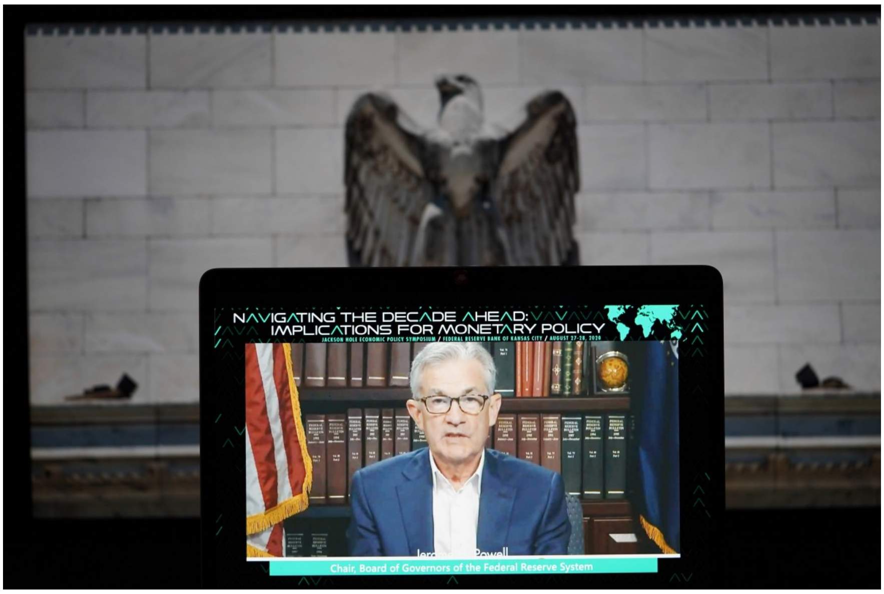
Rates Spark: Fire in the Hole!

The Jackson Hole symposium at the end of this week casts its shadow ahead and we could well get the signal for a sooner and swifter taper with the potential to change curve dynamics and widen the USD EUR rates differential. Until then risk sentiment remains in the driving seat as the market gauges the fall-out from the Delta coronavirus strain



Fed Chair, Jerome Powell, giving a virtual address at Jackson Hole last year

Taper on the mind, but risk remains in the driving seat for now

While the FOMC minutes still left markets guessing about the Fed's concrete plans, officials were more open about a swifter taper in their recent comments. Our economists see the chance that Fed Chair Powell will provide the signal for the taper to begin later this year and with it the impetus needed for the rates market to leave its depressed yield levels finally behind.

That is if it weren’t for the spread of the Delta variant muddying the outlook. What is more, the taper itself is already well communicated and anticipated by markets. An outsized tantrum-like reaction by markets thus seems unlikely.

We remain on the lookout for changes in curve dynamics

However, we think the Fed has more to consider and we remain on the lookout for changes in curve dynamics. If the Fed ever wants to be in a position again to raise its key policy rates without prematurely risking inverting the yield curve, it might be advised to lay the groundwork for a steeper curve ahead of time. The taper could be such an opportunity, especially if the Fed more clearly emphasises de-linking the timing of the taper from the timing of the first rate hikes. The latest FOMC minutes hinted at a desire to do this, and we think it could defer much of the sentiment-driven price action that currently plays out in the bull flattening dynamic towards the belly of the curve with the taper lessening the appetite for the long end.

There is lots of data this week, including the Markit PMIs, durable goods orders and personal income and consumption data. Of course, these will be scrutinised for any hints of a bigger fall-out from the latest resurgence of the pandemic. Our economists are hopeful that any slowdown in activity will remain temporary, with the pandemic in some areas also showing tentative signs of topping out. It also means that for much of the week risk sentiment will remain in the driving seat.

Divergent ECB and Fed policies thrown into stark relief

The publication of the ECB meeting minutes this week should put the diverging paths of monetary policy in the US and Eurozone in stark relief. And later in September the ECB will then have to decide on the pace of QE for the remainder of the year, with a possibility for any slowdown of purchases to be deferred again to a later date. With it, we see the chance for the wedge in interest rates levels that has already opened up between the two at the short end to further feed through into the long end.

> *The wedge between short-end USD-EUR should furher feed into the long-end*

Of course, there remains the direction element to the spread differential, very much for now driven by the swings in risk sentiment. Some technical factors could also muddy the water. While the eurozone has enjoyed reduced activity in primary markets and will still do so this week - only Germany and Italy are scheduled in government bond markets - next week should see a return of action. Long end rates particularly could feel pressure as the next EU deals move into view and also a new syndicated 30Y Bund looms.

If data this week does not suggest an outsized negative fall-out of the latest pandemic resurgence in Europe, as we think it will, then the extremely flat levels of the long end curves could be challenged again.

Today’s events and market view

The main events today are the releases of the flash PMIs which will provide a glimpse of sentiment amid restrictions eased on the one hand, but also a resurgence of the pandemic and ongoing supply chain disruption on the other.

We have the feeling that with the events of the past week at least the rates space has already moved pretty much into the glass half empty view, i.e. market reaction to further disappointments could be less pronounced.

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