Rates Spark: Flat beat

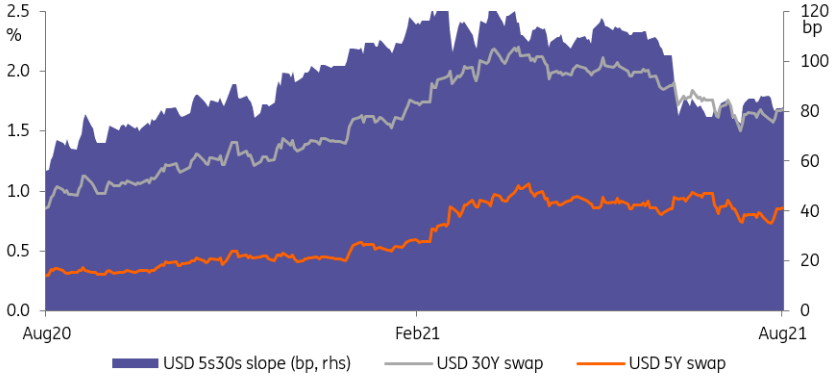
More upbeat economic data this week, and hawkish soundbites, would only displace bond demand towards longer maturities. We may not have seen the trough in rates this year, as flow remains stacked in favour of lower yields. Until September at least.

Source: Shutterstock

Not convinced by further progress

The rate market reaction to Friday's bumper non-farm payroll is the closest thing to a shrug the curve is able to perform. Granted, rates rose across maturities but the continued flattening move suggests no major change in market dynamics as the case for Fed tightening becomes increasingly convincing. Take the 30Y swap rate for instance. Despite Friday's jump it remains a long way away from the levels prevailing in the Spring. A degree of flattening at this stage of the tightening cycle makes sense, but one would expect it to be driven by higher front-end rates rather than by lower long-end yields.

Curve flattening out of last week's NFP means no change in market dynamic



Source: Refinitiv, ING

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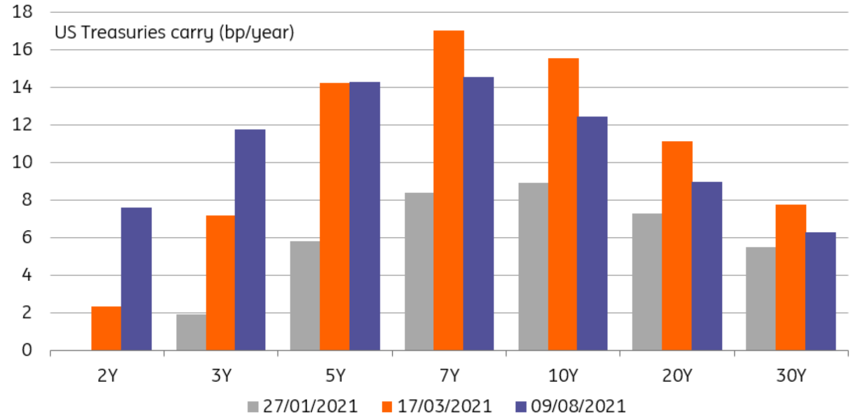
We have long argued against taking the economic signals sent by the yield curve at fair value. A more convincing explanation for lower rates in our view is an excess of demand from buyers insensitive to economic expectations, and to the level of rates, with the Fed being a prime example. Last Friday's jobs report doesn't change this state of play, unless it convinces the Fed to bring its purchases to an abrupt end. What further 'progress', such as persistently high CPI, higher job openings, and hawkish soundbites from Fed officials, would achieve is to displace demand from investors who do care about future yield movements to sectors of the curve less sensitive to Fed hikes. In most cases, this means buying longer-dated bonds despite the improved carry offered at the front-end.

Outright rates, swimming against the current

If the flattening trend has further to run, in our view, one can reasonably question whether we have seen the trough in rates for the year (save for the first weeks of January). Here too we think markets will be hard to convince. Fed purchases continuing at full speed (US$120bn/month) for most of what is left of 2021, and at reduced speed for at least half of 2022, provides a strong argument in favour of buyers. Another one is supply constrained by the looming debt ceiling deadline. Neither are new, but we think they will continue to dominate price action over the Summer weeks.

Carry has improved at the front-end of the Treasury curve but so has Fed tightening risk



Source: Refinitiv, ING

A return to regular issuance flow would at least remove the skew in favour of lower rates

A return to more 'normal' market dynamics in September stands a better chance of restoring balance to rates markets than any economic release or hawkish Fed comment would. We expect that borrowing costs where they are would present a tantalising opportunity for borrowers to lock in low interest rates. Even if this view proves wrong and that appetite for borrowing in excess of what normally occurs in September does not materialise, a return to regular issuance flow would at least remove the skew in favour of lower rates that is evident currently.

Today's events and market view

The Sentix economics confidence index is one of two such indicators released this week (the other being the Zew tomorrow). Consensus is for the index to slightly decline from near-record high, hardly cause for panic, and another indicator that is hard to reconcile with the record low real rates and flat curves that are currently prevailing in much of developed markets.

In the afternoon, US job openings are expected to confirm that the job market is on the mend. Raphael Bostic and Tom Baking are the two Fed officials scheduled to speak today. The burning question is how much 'substantial further progress' the economy has, in their opinion, to make before asset purchases can be tapered. They could conceivably prevent a further drop in rates, but not further flattening.

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