Rates Spark: Front-end driven

Long-end rates remain largely driven by markets' rate cut expectations. Despite some retreat already, they still look aggressive, especially for the ECB. That also leaves near-term upside to longer rates, to which one can also add bearish impulses from a busy primary market

Rate cut expectations have eased, pulling long-end rates up from year-end lows

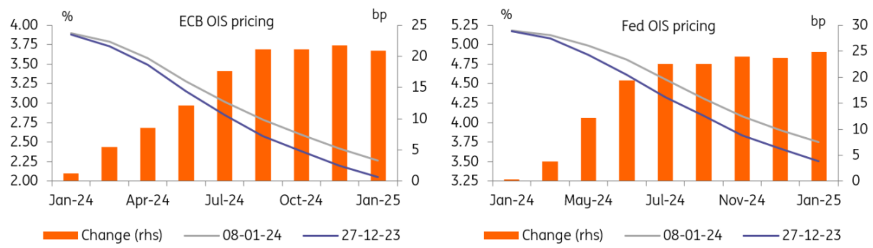
Following the Christmas break the trend for rates has been higher. The final push came with Friday’s US jobs data, but after that strong release that still indicated a loss of momentum markets are struggling to push further beyond key levels.

For US treasuries that is the 4% mark, after having come from a low of 3.8% late last year. In EUR rates the 10Y Bund yield briefly touched 2.2% yesterday, coming from 1.9% late last year, but having since fallen back towards 2.25%.

The central banks’ emphasis on data dependency makes markets more prone to volatility and overshoots in either direction as any new release immediately gets parsed for its policy implications. With regards to US pricing, markets are not too far off from our economist’s view that the Fed will deliver 150bp in rate cuts this year. Markets are discounting 142bp through year-end, although have become a tad too aggressive for our taste by pricing good chances for a first cut already in March. Pricing has receded somewhat already from even more extreme levels.

More noteworthy is that the aggressive pricing for the European Central Bank has stuck, despite recent commentary by the bank suggesting that rate cuts before summer were unlikely. Also recall the ECB indicating it will wait out the outcomes of wage negotiations in the early quarters of the year before thinking about rate cuts. Currently the market is more than fully pricing a first rate cut for April, with an overall easing of 155bp for the year – quite a contrast to the 75bp our economists are looking for.

Rate cut pricing remains aggressive despite some retreat from extreme levels



Rate cut expectations have also driven longer-term rates to an unusually strong degree since November. If one looks at rolling 20-day correlations of the 10Y rates across a strip of say one month forwards, we currently see high positive correlations all the way down to the sub 1Y part of the curve. The last time we have seen a similarly tight correlation from long- to short-end rates was in March last year – not a coincidence as this was the episode around banking tensions in the US. More near-term factors - like the usually heavy supply slate at the beginning of the year - could gain more weight. This week is already stacking up to be quite busy, not just given the eurozone syndicated deals that have been announced but also the UST supply across 3-, 10-, and 30y bonds.

Today's events and market view

Today's data calendar is light, with the US trade balance of note after this morning's German industrial production data. That leaves markets to focus on more bearish factors like upcoming remarks from the ECB's Villeroy and the busy supply slate.

Primary market will be busy with regular auction supply in Europe coming from Austria and the Netherlands. The UK will sell 20Y gilts and, later in the day, the US Treasury sells a new 3Y note.

Next to the scheduled auctions we get syndicated deals from Belgium (new 10Y) and Italy (new 7Y and 30Y tap) and in Sovereign, Supranational and Agency deals from EIB and French agency Cades.

Separately, Spain will hold an investor call regarding this year's issuance plans.

Author

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

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