Rates Spark: A glass three quarters full

Risk-on continues, driven by positive data surprises in the US and with the front end adding the latest push higher, courtesy of the BoE. Today's US jobs report does not look set to break the trend higher in rates, though EUR rates have room to outperform as supply pressure subsides.

Bank of England, in the City of London

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Overnight: optimism continues but a pause in bonds

The buoyant mood in risk assets extended into the overnight session with stock futures reaching new highs for the week but failing to take bond yields along with them. The session was marked by a dearth of fresh market drivers, besides the usual barrage of Fed speakers dismissing the need for tapering asset purchases.

The front end added to the latest push higher, courtesy of the BoE

The upward drift in UST and Bund yields did lose some of it recent momentum despite getting a brief nudge higher from Gilts: The BoE had expressed limited enthusiasm for negative rates which led markets to price out their rate cut expectations with the 1y1y SONIA crossing above the 0%

threshold for the first time since last summer.

In the eurozone, the revival of rate cut speculation seems to have been more of a temporary fad with the weakening EUR relieving pressure on the ECB. Officials have become very quiet on the topic in recent days and forward rates imply less than a 50% chance for a 10bp cut within the next year. It had been as high as 70%.

Positive data surprises have paved the way towards higher UST rates

Data remains in focus with the official US jobs report for January due today. Wednesday's ADP private payrolls number already beat expectations, and the ISM employment indicators were equally strong. No surprise the consensus for today's non-farm payrolls release has nudged to 100K, towards the upper end of our economist's forecast range.

With 10Y UST yields having briefly topped 1.15% yesterday and having failed to break above the 1.2% last month, there could be some consolidation ahead of today's jobs data. With the Fed still holding on to the front end, the curve steepening is bound to run into increasing headwinds. The 5s30s has already steepened to a headline grabbing level of just below 148bp, the highest since 2015. Eventually though a gradual increase to the 1.5% area remains our target for the 10Y if the risk backdrop remains benign.

Prospects for a Draghi government in Italy feed into the positive sentiment

Risk-on has also been a theme in Eurozone government bond spreads. The 10Y Italy/Bund spread dipped below 100bp with the prospect of a Draghi led technocrat government in Rome fueling market optimism. Starting the year we did have a target in mind of 105bp this quarter and 90bp later in the year for the spread, yet driven by steady ECB buying and a gradual economic recovery. The political circumstances have put the latter target in view already, but we would caution that as of now Draghi is still facing headwinds in parliament. Markets may come to recognize that remaining risk after the initial optimism leaving the spread exposed to some profit taking at the 5 year lows. But then, what is the alternative? Spain's 10Y spread, is still at the tightest levels in 10 years.

Today's events and market view

The US jobs data takes centre stage. Our economist expects US non-farm payrolls to have added by 50-100K in January after a posting a 140k decline in December. February should turn out even better with California's stay at home order rescinded. However, our economist cautions that substantial improvements in employment are not going to happen until there is a broader re-opening of the economy, which could still be a few months away.

Given already lofty yield levels it would not be surprising to see some short covering ahead of the figure. But eventually we think the market reaction to the data should be skewed towards higher rates again, if for no other reason that the focus will turn to next week's US Treasury supply. In the Eurozone the drag coming from this week's substantial long dated supply should have ended, leaving room for the UST-Bund spread widen again.

Capping this week's EUR govie supply Belgium issues up to 0.5bn in 5Y and 15Y bonds in an optional reverse inquiry operation.

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