Rates Spark: The stakes get raised

The return of risk-on opens further upside to yields, although US data on Tuesday was weak, and demand at the 2yr auction very strong. The eurozone PMIs paint a more upbeat growth picture and with rate cuts beyond June still uncertain, we may see increased focus on growth going forward. Still, there's a keen focus on the US PCE deflator due Friday

Solid US 2yr auction and a dodgy PMI report heightens anticipation into Friday's PCE

The US 2yr auction was strong. Yields were moving lower into the auction, so to manage an outcome where the paper came at about 1bp “through secondary” was impressive. The indirect bid, which includes the important central bank demand in this segment, was firm, with 66% accepted. This was the biggest 2yr auction on record, and it passed the smell test with flying colours.

A downturn in PMIs earlier in the day set the tone for lower yields. The market had expected rises but instead got falls, and a move back below 50 to boot, which indicates contraction. The narrative underlying the data was also very poor (companies cut payroll numbers at a rate not seen since the Global Financial Crisis). The latter was the dominant reason for the market reaction that took the 10yr down some 5bp from the 4.6% area, to a tad below 4.6%.

The big hitter is still the PCE deflator due on Friday. The solid market expectation is for a 0.3% month-on-month outcome. But if we were to have a 0.2% MoM outcome sneaked in somehow, the likes of today's PMI report plus that would be the type of combo that could spark a material rally in bonds. The thing is, a 0.2% MoM outcome would be a big enough surprise to suggest it's unlikely (not this month anyway).

Improving eurozone PMIs help risk-on sentiment

Geopolitical turmoil in the Middle East brought about a number of risk-off spikes since the beginning of this month, but risk assets had been trading softer already on the back of rates beginning to adjust higher earlier.

Markets now not only seem to discount the risk of escalation with oil prices back lower and a VIX well below last week's highs. It seems they are also getting more accustomed to the prospect of higher rates. Risk-on is making a return and we saw implied interest rate volatilities decline more noticeably over Tuesday's session which is also reflected in spreads more generally tightening again.

In the eurozone, the Bund curve steepened as risk sentiment was helped by upside surprises in european PMIs, where especially services PMIs surpassed expectations. The risk-on move has a bit more juice in our view and thus 10y Bund yields could see another uptick this week. The gradual recovery of the eurozone economy as reflected by the PMIs is something that has been set in motion for some time and shouldn't impact the European Central Bank's decision to start cuts in June. But with less market conviction about the timing of cuts thereafter, markets could start becoming more sensitive to the growth part of the story. The idea would be that the ECB may feel less rushed into a chain of cuts if growth worries abate. But in contrast to the US, a nudge up of the short end should not have a strong impact on tenors beyond two years given that the numbers so far give little reason to reprice the endpoint of the ECB.

US PMIs, however, did not join in on the celebrations, dragging global yields back down later in the session. The disappointing numbers mean that the US composite PMI is now below the eurozone one for the first time in 12 months. Normally markets are more focused on the ISM reading for the US, but all three PMIs coming in well below consensus did not leave rate markets unfazed. However, we also don't think this data point changes the narrative on the US, given that soft data – including the ISM – has been painting a decidedly weaker economy than the official data for a long time already.

Wednesday's events and market view

In terms of data, Wednesday's key release is the US durable goods orders. The consensus is looking for a 2.6% increase in the headline. However, ex-transportation the expected increase dwindles to a meagre 0.2%. In the eurozone, the German Ifo index follows on the heels of the surprisingly strong flash PMI, where services managed to pull the composite above the 50 threshold. There are a few ECB speakers scheduled for today like Francois Villeroy, but more on supervisory topics. A literary event attended by Isabel Schnabel might also not be the prime event to expect policy comments.

Planned auctions for European government bonds had foreseen only a €4bn tap of the German 10Y benchmark Wednesday. However, after mandates from Greece for a new 30Y bond and from the EIB for a new 7Y bond the supply slate looks busier already. French agency UNEDIC will also be in the market for a 10Y social bond. The UK will sell a new 30Y gilt via syndication and in the US the Treasury will sell US$70bn in new 5y notes.

Authors

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

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

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Disclaimer