Rates Spark: Lockdown November

‘Lockdown November' failed to benefit government bonds much. We think it is too early to talk about a similar ‘dash for cash’ to earlier this year. In fact one could argue that US yields have held up quite well (down but not out). No ECB easing is expected today and we argue cheaper liquidity injections would tick many boxes and help bolster market sentiment.

Source: Shutterstock

US 10yr finds a floor in the 75bp area

Volatility in the risky asset space has been high in recent weeks, and it spiked again yesterday. But despite this, and with the coincident collapse in equity markets, the Treasury market has not been that fussed. Yes the 10yr yield has fallen from recent highs near 85bp, but the path down to 75bp was not on pure bond market negatives, but more on a residual effect coming from a bigger focus on risk asset vulnerabilities.

Even if we get some respite today, risk asset concerns will likely persist ahead. With that as the backdrop, and with Covid concerns elevating in the foreground, it is a tad reassuring that the US curve is managing to hang on to the steeper shape that has evolved over previous weeks. The curve has directionally flattened of late of course, but an underlying steepening impulse is not far below the surface. The issue in the near term however is the weight of risk negatives.

The medium-term view still envisages a steepening, and eventually a 1-handle on the 10yr. But that is a 2021 call. Nearer term, news that the respected Anthony Fauci does not see a vaccine in effect in the US until January 2021 does not help sentiment as we struggle with elevated Covid concern as we progress through Q4. To some degree, there is a tactical flattening outcome here.

'Lockdown November' doesn't benefit bonds…

In light of the more resolute move toward national lockdown in France and Germany, we are not surprised at the poor performance of risk assets this week Nor is it a surprise that the expected inaction at the upcoming ECB (see below) and Fed meetings is not providing much solace. We are more circumspect when it comes to providing an explanation for rates price action however.

Counter to our view that 'lockdown November' is the more palatable option politically than taking the same measure one month later during the Christmas break, 10Y German yields made only slow progress towards our -0.70% target so far this week. As we wrote earlier, the proximity to the US election could explain reluctance in investing in fixed income, but we would expect bond short-covering rather than a sell-off to dominate price action as the vote draws closer.

… because of 'dash for cash 2.0'?

An potential alternative explanation for the poor performance of supposed safe havens is that a de-risking/deleveraging trend among investors is pushing them to sell liquid investments to park their money in cash or cash-like assets. Indeed, a simultaneous sell off in stocks and government bonds would bring painful memories of market dislocations in March of this year, when the first lockdowns were imposed.

We think it is too early to talk about a 'dash for cash 2.0' but the fear of a repeat is no doubt on investors' minds. It should be said that since March, central banks have put significant safeguards in place. For instance, the Fed and ECB have active asset purchase programs that could provide liquidity to their domestic bond markets if the need arises. Similarly central bank liquidity swaps guard against a widespread shortage of USD funding.

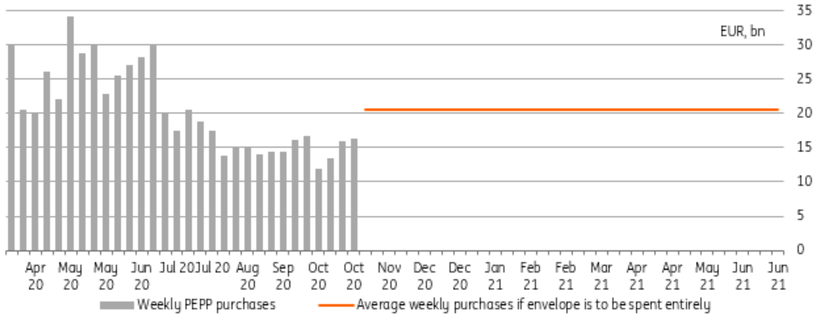
The very fact that these stopgaps exists should limit the likelihood of market stress. We see no sign of a wild swings in swap spreads or a cheapening of USD 2s10s30s butterfly, both of which forewarned of the market volatility that happened in March. Similarly, short-dated cross currency bases have remained well behaved so far.

ECB: keeping its (pep)powder dry

Ahead of today's meeting, the unanimity of our peers surveyed by Bloomberg were calling for no policy action before December. We expect that the gyrations in stock and other risk assets, as well as downside risk to the outlook from more stringent lockdowns have shaken that confidence.

It remains that an increase in QE is neither urgent (the ECB has spent only half of its PEPP envelope - one of its two QE programs) nor a decision to be taken lightly (new economic forecasts in December, including for 2023 would provide a more solid basis). Our economics team thus thinks an increase of the Asset Purchase Program will only be announced in December. The message at this meeting could be further muddied if dissenting opinions are voiced in the coming days, although 'ECB sources' news has been conspicuously absent this week.

The ECB can easilly step up its purchase under the current PEPP envelope



Source: ECB, ING

TLTRO: the unsung hero

The list of other policy levers the ECB could pull include extension of favourable TLTRO (long term liquidity injections to banks) terms, more generous bank reserve tiering, and signalling faster QE purchase within the current envelope. The former would tick the most boxes in our view. It would signal that the ECB is taking the recent turn of events seriously. What's more, TLTROs are a tool that has a proven track record of boosting the flow of credit to the economy, as its recent Bank Lending Survey demonstrates. There is also a historical precedent of announcing easier liquidity injections prior to QE boosts (most recently in the spring of 2019).

It is an open question whether this would be enough to bolster risk markets until the December meeting, and if the concept of 'lockdown November' is adopted by more countries across Europe. Besides its impact on lending volumes and rates, its main benefit for financial markets would be its strong dovish signal. Other benefits would include cheaper funding to banks and a reduction in systemic risks. On balance, we think this would be enough to stop the widening of sovereign spreads after 10Y Italy-Germany reached our 140bp target yesterday.

Today's events: ECB meeting, German inflation, US GDP

There is a hefty economic agenda today, dominated by the ECB meeting (see above), German October CPI, and advance US Q3 GDP.

Italy will also sell 5Y, 10Y and floating rate bonds.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Disclaimer