Rates Spark: Losing its cool

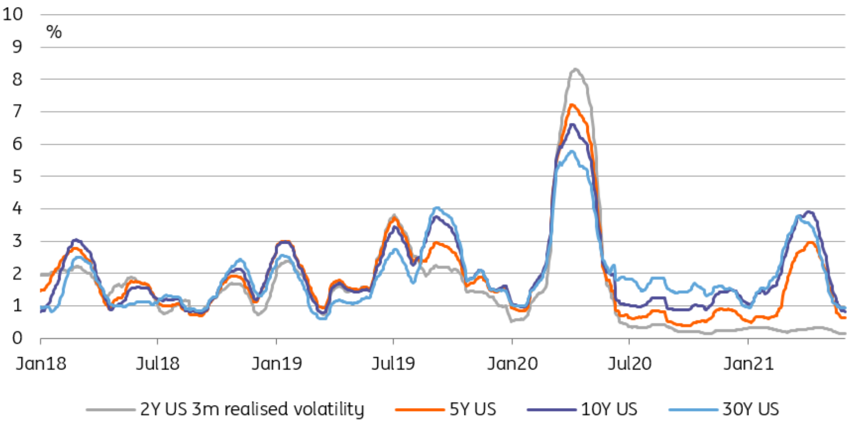
Taper talk is back, and with it the risk of higher USD rates volatility. Big liquidity going back to the Fed has eased, but is still very large. NGeu will make an earlier than expected start in the Euro bond market and is set to become a key contributor to the growth of sovereign and supranational debt markets over coming years as states rein in their deficits.

Source: Shutterstock

The Fed is back in the driving seat

This week has brought a subtle change in market behaviour that may well extend into the coming sessions: USD rates seem to have lost some of their cool. If our economics team's expectation for a 500k May payroll figure in this Friday's report is any guide, we doubt the strength of the labour market has anything to do with it. And indeed, the labour component in ISM Manufacturing yesterday reinforced fears that supply constraints may be holding back further gains.

Taper talk comes as US Treasury volatility is at a record low



Source: Refinitiv, ING

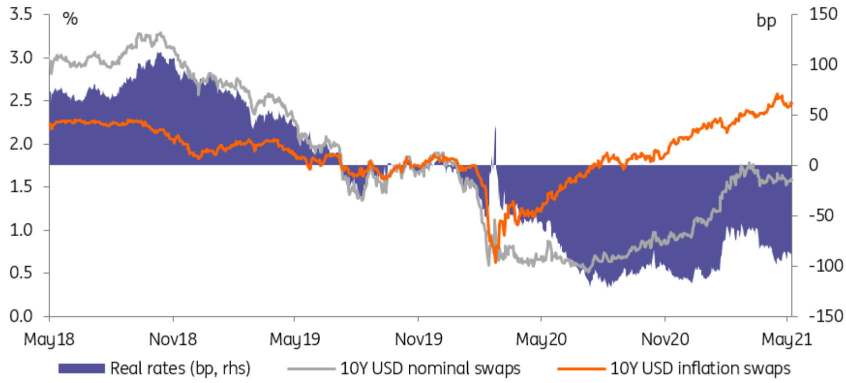
We see the real culprit as being increasingly persistent taper talk. More and more officials are publicly drawing the conclusion that bottlenecks, an erstwhile reason for caution, are now an argument to start the tapering debate. To be clear, the tone is still cautious, and we expect any announcement to take place no earlier than at the Jackson Hole symposium in August. Nevertheless, we think this is enough to bring a change in narrative in rate markets, whereby concerns over increasing price pressure and bottlenecks are no longer shrugged off by USD rates.

And the taper talk comes against a backdrop where the Federal Reserve continue to take in considerable liquidity in its reverse repo facility. It has eased back down to the USD 450bn area, but this is still a considerable amount, especially outside a month- or quarter-end. The fact that the volumes going back to the Fed are a tad lower takes some pressure off, but the volumes themselves remain large.

The Federal Reserve continue to take in considerable liquidity in its reverse repo facility

This continues to coincide with downward pressure on front end rates generally, in turn coming from the build in implied excess liquidity generated by the Fed's ongoing ultra easy policy. This continues to provide considerable support for the US system (e.g. 3mth Libor at or close to historical lows), and by extension for the economy.

US real rates have remained unresponsive to the rising tide of liquidity and of Fed support



Source: Refinitiv, ING

This remarkable support is at the very least providing the economy with the best chance of complete recovery. Real yields remain unresponsive through, remaining more reflective of extreme stimulus than of a discount for sustained recovery.

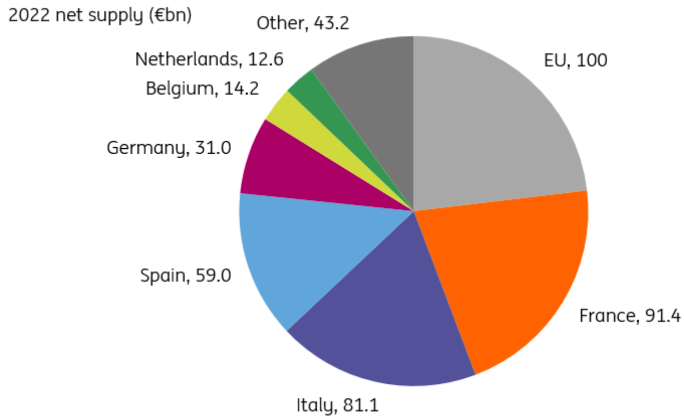
There's a new kid on the Euro-block

The European Commission (EC) announced yesterday that the first bond issuance to finance its recovery fund (dubbed NGeu) will take place in June. Separate sources had the size of this first syndicated deal at €10bn, which is consistent with SURE bond sales earlier this year. The EC also added that €80bn of long-term bonds, which it defines as having a maturity longer than 3Y, will be sold this year. This is greater than our initial forecast and reflects earlier timing for the first deal.

> *We doubt that the most risk-adverse investors will put it in the same liquidity category as sovereign debt*

Comments putting the EU bond market on par with the largest Euro sovereigns have to be taken with a generous helping of salt. The fund's target size of €750bn at 2018 prices compares with the €2.2tn of Italian sovereign debt. The same figure is €2.1tn for France and €1.5tn for Germany. What's more, the temporary (at least on paper) nature of the NGeu programme means we doubt the most risk-adverse investors will put it in the same liquidity category as sovereign debt.

EU net bond supply should outweigh that of other most other sovereigns next year



Source: European Commission, state debt management offices, ING

This is not to downplay its importance however. EU net bond issuance upwards of €100bn next year will compare to €320bn for the whole of the EUR government bond (EGB) complex. We do not doubt the market's ability to absorb this amount of debt but it bears looking at public finance announcements as 2022 deficit forecasts firm up. Should sovereigns fail to rein deficits in as much as the EC expects, there will be more competition for demand. The ECB will also have a key role to play in absorbing this new supply if it boosts its APP purchases next year.

Today's events and market view

Economic data will take a breather today. Markets will have to contend with another barrage of upbeat (we think) releases later this week, as well as long-dated supply from France. This should be enough to prevent further drops in EUR rates even as the ECB meeting approaches and dovish expectations have been set.

German is scheduled to sell 5Y debt today in a quantity that we think will fail to register in outright rates. We wrote yesterday that we disagree with the pick-up in volatility in the 5Y sector in reaction to better economic data, and discussion on further asset purchases may well drive that point home, and result in boosting interest in the sector.

USD rates will keep a close eye on Fed comments with no less than Charles Evans, Raphael Bostic, Robert Kaplan, and Patrick Harker due to speak. Taper talk is rife (see above) and we doubt the word has lost all of its ability to shake the bond market, especially complacent carry trades. We thus see the balance of probability in favour fo higher USD rates today.

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