Rates Spark: Low rates puzzle

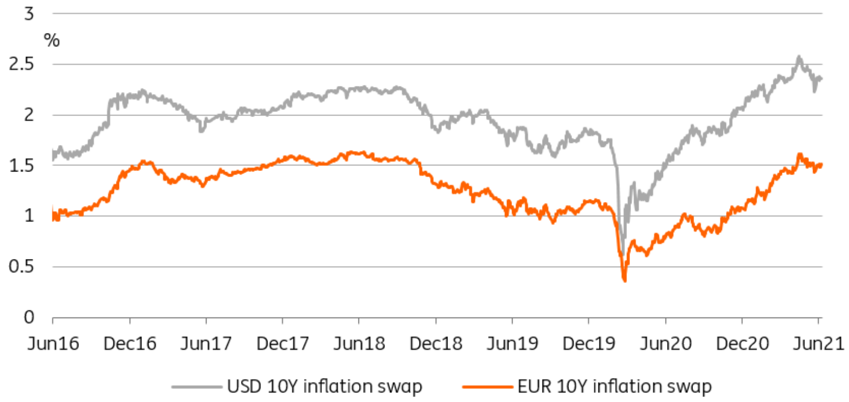
Low rates are hard to reconcile with economic fundamentals, but their stability is drawing more investors in.

Low medium term growth expectations are only one possible answer

There are plenty of opportunities this week for rates to wake up to the risk of earlier central bank tightening, most prominently from the Fed, but the current mood is one of despondency when it comes to reflecting better economic prospects. The puzzle presented by low rates even as inflation expectations are adjusting higher is not an easy one to solve.

Our first instinct would to assign their inability to rise to depressed economic expectations but one has to factor in the fact that exceptional degree of uncertainty about medium term expectations make such reading difficult for long-dated interest rates. Worse still, some market indicators such as inflaiton swaps point to a healthy economic outturn for the next ten years.

Low economic expectations could explain low rates but inflation swaps still point upwards



Source: Refinitiv, ING

> *Stability draws more buyers in, thus creating a self-reinforcing dynamic*

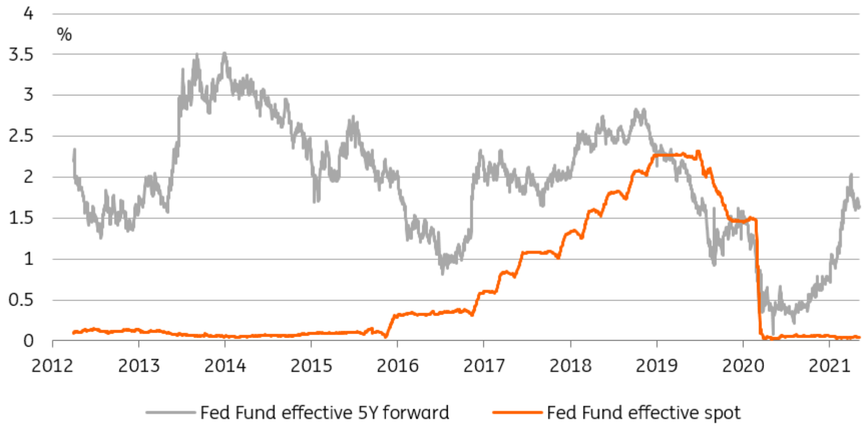
Dismal economic expectations may be justified, as interest rate investors reflect on the past decade of anaemic growth inflation and could be tempted to extrapolate. The inability to gain a satisfactory degree of confidence when making economic predictions beyond a few years means ones has to factor in flow and risk sentiment in making interest predictions. Using this approach rather than economic fundamentals yields an altogether different insight: stability draws more buyers in, thus creating a self-reinforcing dynamic. The same goes as markets are able to shrug off more inflationary warning signs and hawkish soundbites.

The stakes are rising ahead of the Fed's tapering announcement

It is tempting to say that this reasoning applies to today's ISM services and tomorrow's FOMC minutes. Rates markets seem to have grown numb to the risk of the Fed being forced into tightening policy more abruptly than it would like to by higher inflation. This may be a reflection of the market's tendency to derail tightening expectations but the proximity to a tapering announcement later this quarter raises the stakes around Fed communication.

Should the current market mentality continue, more hawkish soundbites should mostly affect the short-end of the curve, as investors not seem to believe in its ability to tighten policy beyond a short-lived cycle taking the terminal rate around 200bp, compared to 250bp in the Fed's forecast, and 225bp in the previous one.

USD rates markets doubt the Fed's ability to raise rates above 2%



Source: Refinitiv, ING

Today's events and market view

More exchange of views is possible today ahead of the ECB's 'conclave' aimed at ironing out differences between governing council members about its strategy review. Pablo Hernandez de Cos of the Bank of Spain, and VP Luis de Guindos are both scheduled to speak.

The US' ISM services will be the main economic releases of the day but the interest in its employment index may be less than usual as it is published after the June jobs report. We do not expect the release to put investors buying debt, and expect stable to lower interest rates.

Austria will auction 5Y/10Y debt and Germany will sell linkers. France also mandated banks for the syndication of a new 30Y that will aim to raise €5bn.

Authors

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

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

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