Rates Spark: Make up your mind

The risk tone has worsened, but month-end flow as well as supply muddy the picture and we see the risk of a pullback today. The ECB has provided the market with a clear reaction function to trade off, the key data releases ahead will help US markets get a clearer grasp of the Fed's.

Federal Reserve

Source: Shutterstock

Delta variant weighs on risk sentiment

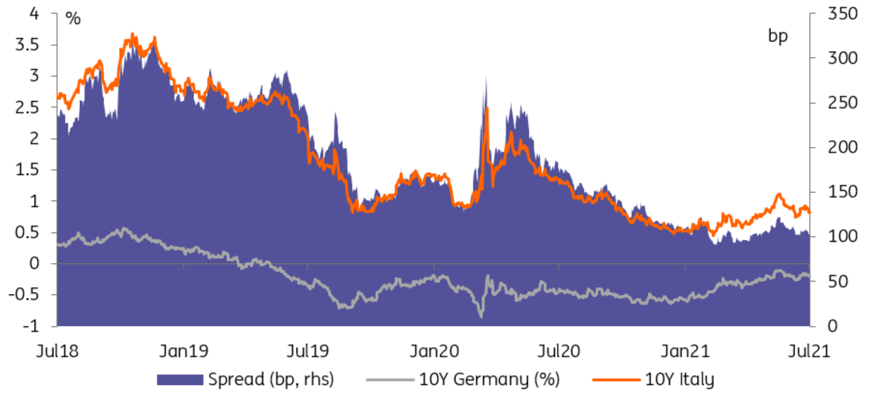
It is hard to disentangle all the drivers of the bond market. Yesterday witnessed a strong performance led by a bull flattening of the EUR curve. Perhaps it was that the EU supply has been digested, and some of the strength may be due to month-end extensions. If the latter were the case, we could see some pullback today, especially with the Spanish and French supply looming early in the session.

However, the spread of the Delta variant has also put a dampener on market sentiment as it puts the faster reopening trajectories at risk. Eurozone economic sentiment rising to the second highest on record yesterday has been flatly ignored by markets.

The ECB's reaction function seems clear ...

A sense of risk-off does not necessarily mean wider eurozone government bond spreads. Here markets should rather be eyeing the reaction function of central banks. In the case of the ECB the barrage of dovish comments suggests that an extension of current support measures would only get more likely should we see a further deterioration of reopening prospects. Not too long ago the market seemed almost fully subscribed to the ECB's current plans to end the net purchase phase of the pandemic emergency purchase programme (PEPP) by the end of 1Q next year – that is judged by the June survey of monetary analysts.

Eurozone bond spreads benefit from a clear ECB reaction function



Source: Refinitiv, ING

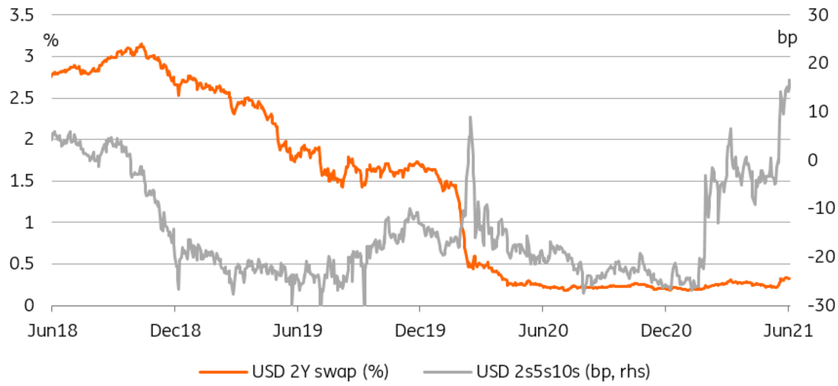
This leaves room to for markets to price in more prolonged support, or at least somthing that will cushion the end of net PEPP such as higher volumes via the traditional asset purchase programmes (APP). A direct beneficiary would be the Italian bond market. In the 10Y space we have already seen a retightening of spreads over Bunds by c.5bp over the past few days with a push yesterday. But then – speaking of disentangling – we also had Italian bond auctions with decent demand yesterday.

... but the market still has to make up its mind about the Fed

USD rates traded comparatively calmer yesterday. One reason is perhaps that the market still has to fully make up its mind of how to judge the Fed's new reaction function follwing the hawkish surprise at the last Fed meeting and the subsequent communication. The upcoming key data releases could provide more clarity before we go into the summer. The case for the US front-end to price in chances for earlier Fed interest rate hikes appears clear, how the long end should react is less clear cut.

A firm ISM manufacturing today should be a given, but the greater focus will be on the supply bottlenecks that could indicate more price pressures. The Fed's Kaplan acknowledged that the US is seeing "broadening price pressures rippling into a broader range of items". He has been a proponent of scaling back the Fed's bond purchases rather sooner than later, especially as these cannot address the current supply problems. Of course the doves will note that the job market is still far from its pre-pandemic performance, but also here tomorrow's data could provide a bit more clarity on where the issues lie, especially if higher wages indicate demand for workers not being the problem.

Watch the front end as we get a clearer view of the Fed path



Source: Refinitiv, ING

Today's events and market view

To the extent that yesterday's strong performance was driven by month-end extension there remains a risk of a pull back today, especially as we also get substantial supply from France and Spain. In data the final Eurozone manufacturing PMI release is accompanied by the first readings for Italy and Spain, but this data is unlikely to move the needle as markets are eyeing the uncertainty ahead caused by the spread of the Delta variant.

US data should be more relevant with big releases ahead. Today will see the release of the manufacturing ISM, which should highlight the supply chain strains that are putting up costs and boosting the chances that inflation stays higher for longer. How markets react to these readings could determine the behavior of rates over summer. They should provide a better indicator of how seriously markets have taken the Fed's hawkish warning shot – we are watching the front-end.

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