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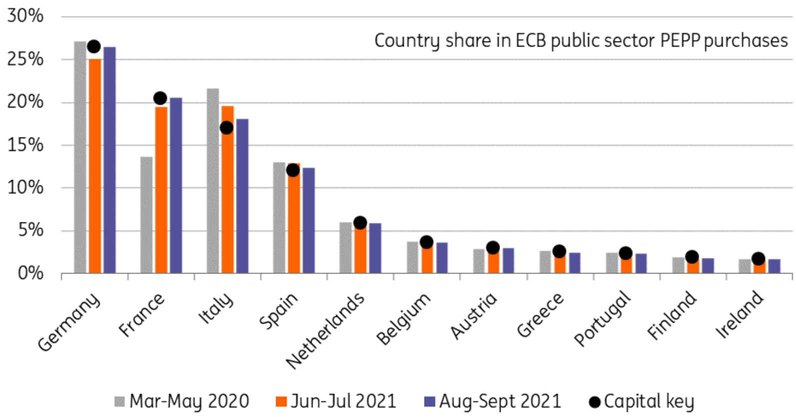
Rates Spark: More divergence on the cards

USD markets are pricing in a number of growth-boosting developments. EUR rates are more circumspect, both on technical and fundamental factors. This augurs for more widening in the spread between USD and EUR market rates. This makes directional sense. There may be volatility along the way as we face into US elections, but divergence still dominates.



Source: ECB, ING

More USD-EUR long-end rates divergence

Looking under the hood of recent price action might yield a more balanced view of the events that have triggered the mini Biden reflation trade experienced in USD rates so far this week. For instance, there can be reasonable doubts about Congress' ability to strike a fiscal stimulus deal, or whether investors can trade a Democratic 'sweep' in less than a month's time with a sufficiently high degree of confidence.

Markets though, are forward-looking in nature. Even on thin volumes due to most investors being side-lined, market moves typically occur prior to the event they are 'reacting' to. The US election is no exception and barring an unexpected turn in the polls, or a collapse in fiscal deal hopes, we see a stronger case for the current trend to extend in the coming sessions.

What is for sure is that US macro data has consistently surprised to the upside in the past month.

Market rates refused to pay too much attention as risk assets were wobbling, and the macro outlook was becoming even more uncertain. In fact, we feel that market got caught a tad short on duration and had in fact pared back credit risk. Some short covering in rates contributed to the outsized move. It is in the direction that we favoured and called for, but we also see technical factors that likely overstated the short-term moves.

105bp our target spread between 10Y USD and EUR swap rates

The stronger performance of EUR rates, and widening relative to their USD counterparts also seems to confirm our view that both technical and fundament factors point at a divergence relative to other currencies. Yesterday's divergence between Spanish and Italian services PMIs seemed to confirm what awaits countries where more stringent measures are put in place to palliate the rise in covid cases.

ECB revealed a strong focus on public sector QE over August/September

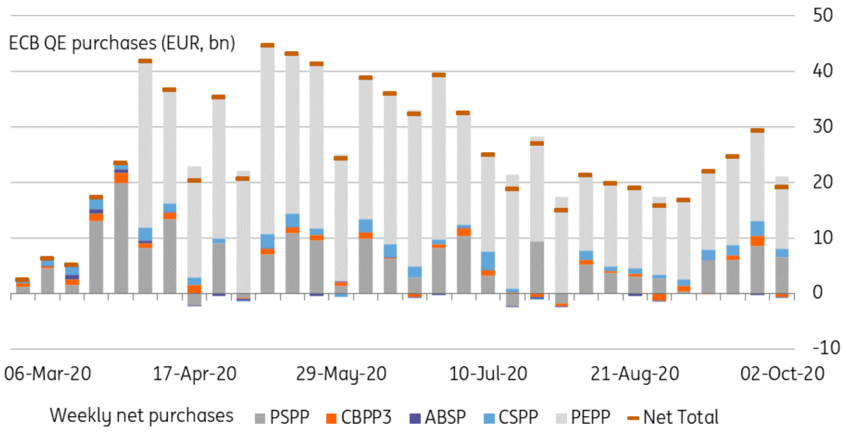
The ECB released the third set of detail data regarding its purchases under the pandemic emergency programme (PEPP), this time for the months of August and September. We already knew from the monthly headline data that purchases slowed over the summer, pushing the purchases to below €60bn in August before picking up again modestly to €67bn in September.

What is now revealed is that over the past months the ECB was almost entirely focused on public sector securities, i.e. in total a net of €126.8bn were bought. In corporate bonds a net of only €2.7bn was acquired, covered bond holdings were kept flat while commercial paper was allowed to run off by €2.7bn.

While volumes were lower, the ECB did use the opportunity of calmer market conditions to even out some of the deviations vis-à-vis its capital key guidance. Purchases in Italy were scaled back to make up 18%, still somewhat above the capital key-implied 17%. Purchase shares in Germany and France were increased to even a tad above their respective capital keys. In Germany the ECB also increased the weighted average maturity (WAM) of its portfolio holdings from 4 years to 4.5 years, which implies purchases somewhat further out the curve and/or a roll-off of t-bill holdings. The figure is still below the 6.6 year WAM of the German public sector securities universe the ECB could tap into, though. The potential for German purchases to catch up to the eligible universe's WAM should prove, alongside lower supply in Q4, another tailwind to direction.

Notably, the share of purchases in in the European Supra space declined to 4.6% from previously above 7%. In absolute terms that is just €5.8bn over the past two months, versus around €14bn in each of the previous observation periods. That said, it still topped the combined €-gross issuance of EIB, ESM, EFSF and EU over August and September of €4.3bn. Going forward, though the EU starting to fund its SURE programme should provide the ECB with a larger market to tap into in coming months.

ECB net QE purchase slow again over the past week



Source: ECB, ING

Today's Events: more central bank speakers

Powell and Lagarde are both due to speak publicly today, ahead of policy meeting releases later this week.

Bond sales today consist of 4Y/10Y Austria and 10Y/16Y German linkers. The US Treasury sells 3Y debt today but 10Y and 30Y sales later in the week should put more (upward) pressure on USD rates.

Authors

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

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