Rates Spark: Nice to have

Biden's infrastructure plan came and went without major surprises. We argue that the steady drumbeat of strong economic data is the more important factor in dictating the pace of higher USD rates in the near term. An additional fiscal package is merely nice to have. The rest of the week should confirm this.

Source: Shutterstock

Nice to have: infrastructure package

Biden's infrastructure announcement came and went. The headline investment figure was in line with press reports: $2.25tn will be peppered over transport, energy, high speed broadband, manufacturing subsidies etc. The funding part of this plan was equally well telegraphed, with a increase in corporate taxation being the main provision. Given the lack of major surprise, market reaction was understandably sanguine both in US Treasuries, an in risk assets. Comments into and around the announcement suggested that a passage through Congress, aimed for by July according to democrats, along partisan line is a more likely outcome.

Market reaction was understandably sanguine

It is important to note that this, and the next, fiscal package will play out on a much different timescale than the previous ones centred on sending cheques to households to avert the worst of the near-term pandemic economic impact. First, approving them should prove a much more acrimonious process without pandemic-related urgency. Secondly, infrastructure spending is notoriously slow to implement. Both factors make it difficult for markets to price their impact accurately, especially since some of the benefits should accrue by the time the Fed's tightening will be firmly in sight.

More important: economic recovery

Helpfully, the US growth story is pushing rates in the same direction anyway. As much as the growth potential of the fiscal packages unveiled, and yet to be unveiled, could be significant, we are of the view that rates markets don't need further encouragement from the official sector to sell off. The bigger story in the near term is the strong economic momentum created by the post-covid recovery, and previous rounds of fiscal stimulus.

The US growth story is pushing rates in the same direction

Today's manufacturing ISM, and tomorrow's job report, should act as reminders of that fact. The former especially could confirm that a sector of the economy that has had a good pandemic, is going from strength to strength. Downside risk in this release could come from FX, with the Dollar index rising over 3.5% in March.

2.9%

Our forecast for average US inflation over 2021 and 2022

Well above the Fed's tolerance band

Taking a step back, our economics team forecasts CPI inflation averaging 2.9% in 2021 and in 2022. This is more than just a temporary spike, and this is well above the Fed's stated tolerance for higher than target inflation. Besides the impact on monetary policy, already anticipated in part by the OIS curve, these inflation levels would make sub-2% valuations for 10Y US Treasuries hard to sustain.

Today's events and market view

Eurozone manufacturing PMIs today are mostly second readings except for Spain and Italy. It might be too early for the fresh covid-related restrictions to show up in survey-based indicators but we would expect the service sector to be most strongly affected anyway. There are reasons to be cautious about the near term outlook in Europe, notably after Italy and France announced fresh restrictions lasting at least month, but we think EUR rates wouldn't resist the temptation to rise alongside their USD peers.

Jobless claims and ISM Manufacturing make up today's US economic slate. A strong dollar poses a potential downside risk for the latter but yesterday's Chicago PMI suggests the sector remains in rude health. We think this is sufficient for the USD rates sell off to resume. This is particularly true as purported quarter-end rebalancing-related support should fade for 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