

## Rates Spark: Pause for thought

US Treasury yields have dipped, but we doubt there is significant downside. The 5yr is on a cheapening trend, and there appears to be too much risk-on. We also highlight some technical drivers (US auctions, specialness and front-end debate) as we wind up for the ECB tomorrow against a backdrop where less-said-the-better might just be the most sensible approach.



Federal Reserve

Source: Shutterstock

### Some US technicalities, but important ones ahead

Back when Covid broke, the Federal Reserve gave US banks a break by allowing them not to include Treasuries in the calculation of the supplementary leverage ratio. The rationale for this was to provide banks with more room to provide credit to borrowers, without the need to raise offsetting capital.

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One year down the line, this decision is under scrutiny. After all, this is an international ratio target, where US banks optically now get softer treatment. The counterargument goes that it is too early to withdraw this, as the crisis is far from concluded. But if it was reversed, it could mean that US banks offload the additional \$400bn that they have built up in Treasuries. This is not a front and centre risk, but it is brewing.

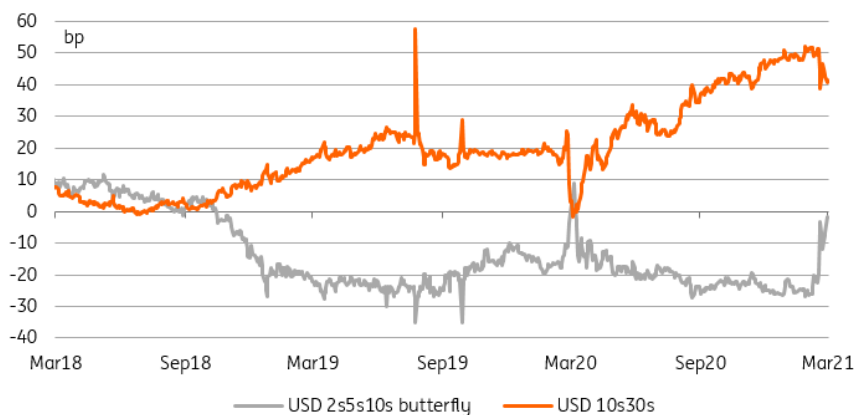
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Meanwhile there is a growing possibility that the Fed may not need to hike the rate on excess reserves, as the funds rate continues to hold comfortably above zero. We'd still argue that an IOER hike is still more probable than not. With SOFR just a couple of basis points away from zero, there is a generic incentive to tighten things up on the front end.

## 5yr continues cheapening, 30yr richening



Source: Refinitiv, ING

An offsetting positive element that takes some pressure off has been a reduction in specialness attached to the 10yr, which had been trading close to the key -3% level. This is away from extremes now as we head into the 10yr auction. The decent 3yr auction yesterday augurs well for a decent takedown in the 10yr today. Although a lack of concession into it heightens the risk for some tailing. This will be a key barometer of sentiment on market levels, with the 30yr hot on its heels tomorrow.

## Rates are taking a breather on the way up ...

10Y USTs managed to hold on to their gains with yields staying below 1.55%. A lot may be in the price already and risk events like the upcoming auctions are well flagged. With the House now set to vote on the stimulus bill, attention could soon turn to the infrastructure bill which might prove more difficult to pass.

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*Yesterday's stabilization in rates looks fragile.*

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However, yesterday's stabilization in rates still looks fragile. On the yield curve the telltale 5Y point has not really managed to recover, what we are seeing rather looks like a brief pause at overall still rich levels in the grand scheme of things. Today's inflation data may see only a moderate rise in prices, but there should be an acceleration ahead in 2Q as the re-opening of the economy continues. Our economist expects headline inflation to move above 3.5% which could also lead to a change in language from the Fed at the June FOMC meeting surrounding the prospects for a tapering of asset purchases. From there the step towards talking rate hikes is only a small one, which the 5Y point on the curve should feel in particular.

## ... but just ahead of the ECB we don't want to read too much into it

The ECB portfolio redemptions data confirmed that there has been little effort so far by the central bank to proactively lean against the increase in rates – that is at least until last Wednesday. €18.2bn in gross PEPP buying is broadly in line with earlier weekly volumes. What we also cannot observe beyond the headline volume are any tweaks in the duration bought or deviations from the capital key.

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Without being able to tell if anything in the ECB's approach has changed since then, EUR bond markets too did have a bit of a respite yesterday. Dipping below -0.3% 10Y Bund yields were up to 5bp lower at one point yesterday, with curves flattening and spreads tightening. In particular the 10Y spread of Italian bonds over German Bunds slipped back below 100bp again, still some way above our 75bp forecast for later this year. Yesterday's 15Y EU social bond deal to finance the SURE programme saw an order book of €86bn also indicating some returning appetite for duration at these levels. After the slightly larger than anticipated €9bn deal, the EU still has plans to raise up to €13bn later this month.

Ahead of the ECB meeting we will not read too much into a brief episode of relief. We expect the ECB to shy away from announcing concrete action this week to stem the rise in yields. Frontloading of purchases on a larger scale may only serve to delay the increase in rates, our envisaged endpoint of 0% for 10Y Bund remains unchanged.

## Today's events and market view

Expectations for the ECB are already low but having Lagarde deliver the disappointing message is another thing. Before attention fully turns to the ECB though, the US still has some time in the spotlight: In data the US CPI release should show headline inflation move a little higher primarily due to rising gasoline prices, to 1.6% y-o-y from 1.4%, while core (ex-food and energy) should stay at 1.4%. Later, the US Treasury will sell US\$38bn in 10Y notes. Being well flagged, a repeat of the disappointing 7Y auction performance which had sparked the first sell off to 1.6% in 10Y yields looks unlikely this time around. In politics the US House is likely to vote on the stimulus deal today.

In supply Germany taps its 5Y OBL (€5bn) and Portugal is out reopening 6Y and 10Y bonds (up to €1.25bn). France not opting for a green OAT deal this week has left room for mandates from CADES for a 8Y social bond and from AFD for a 15Y bond, likely today's business.

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