Rates Spark: outcome-based

One weak US payrolls number does not change the big picture, and one big inflation print tomorrow will likely not also. It will confirm a big rise in prices in the past year though. That's a clear outcome, but the Fed needs more – a string of them. The rise in Euro rates has been larger in recent weeks, even though the oomph is US driven. Lots of contradictions

Source: Shutterstock

US rates getting real in deep negative territory - now what does that tell us?

The collapse in US real rates deeper into negative territory (10yr now at -93bp) is not a post-payrolls phenomenon. US real rates were on the slide well before that. In fact, the 10yr is down some 30bp in the past 6 weeks.

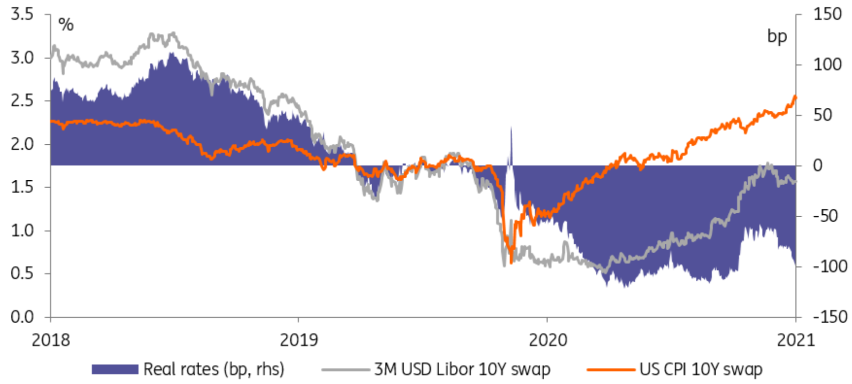
In the meantime the inflation discount has built further. In fact, the fall in nominal rates plus a build in inflation expectations has acted to push real rates deeper negative; or at least that is one interpretation. It is also true that big buying in inflation-linked paper acts to place real yields under downward pressure, by definition.

There is an element of medium-term macro angst risk in the price that must be appeased before market nominal rates can safely roam higher

But the outcome is perverse. This is a bond market that has indeed built an inflation discount (e.g. the 5yr breakeven inflation rate is 2.75% – that's a market expectation of 2.75% inflation every year for the next 5 years (albeit unadjusted for a term premium). At the same time, its a bond market that is discounting quite a poor medium-term growth outlook (negative real yields).

Is there an inflation risk or isn't there? If there is, surely real rates should be higher. The fact that they aren't can't be all explained away by an excess of demand over supply for fixed income (although there is some merit here e.g. Fed buying). And if it can't be, then there is an element of medium-term macro angst risk in the price that must be appeased before market nominal rates can safely roam higher. We'll get there. But it's taking some considerable pause for thought first.

US real rates have dipped lower in Q2



Source: Refinitiv, ING

Current ECB buying pace loses relevance as markets eye the bank's strategy ahead

ECB purchases via the pandemic emergency programme (PEPP) amounted to €16.3bn last week, down from €19bn the week before. Not that it isn't important, but weekly figures are distorted by redemption flows and the recent monthly data revealed the "true" target of €80bn per month. More importantly, the market is already looking ahead, beyond the current phase of faster buying.

The ECB has continued to put emphasis on its June meeting where a decision on the pace of purchases will need to be taken. Chief economist Philip Lane tried to leave the outcome open yesterday, but others have been more openly leaning towards reducing the pace again and have started to mull the strategy surrounding the current prospective end of net PEPP purchases at the end of March next year. With Klaas Knot and Hernandez de Cos we get speakers representing the opposite ends of the argument today.

Italy has become a casualty of ECB tapering discussions

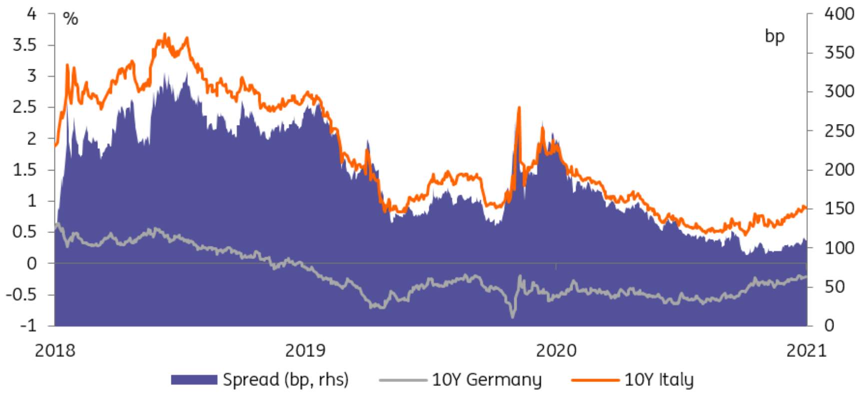
Italian bond spreads over Bunds have been one casualty of this discussion moving into the open. There was some recovery yesterday, but perhaps more on the back of technical factors surrounding (waning) expectations of the next long-end deal from the country. We believe spreads are still too wide given the impact of Italy's significant fiscal efforts amid a shift of political sentiment also in other areas of Europe, not least in all important Germany.

> *We believe spreads are still too wide, given the impact of Italy's significant fiscal efforts*

Staying with Italy's fiscal response to the Covid crisis, our economists calculate that it amounts to a total of almost 22% of GDP. This takes into account all fiscal spending, not just in connection with the EU's Recovery and Resilience Facility for which countries submitted their plans last month. While the figure for the Eurozone at an aggregate level may seem underwhelming, Italy has made full use of the available EU funds putting the relative size of its response in the vicinity of what is observable in the US. The additional caveat of course is that the spending is spread out over the period until 2026 in most cases.

On a side note, so far the individual country plans submitted for the Recovery and Resilience Facility currently amount to €433bn in grants and loans out of the total €673bn available. As the facility pays out 13% percent of the support upfront we also get a better sense of the EU's funding need this year – if ratified in time.

Italian spreads do not reflect Europe's fiscal effort



Source: Refinitiv, ING

Today's events and market view

As bond yields drift higher again, it appears that markets have started to increasingly heed the Fed's outcome-based approach, where one payrolls number does not change the bigger picture. One could argue the same will count for the inflation data tomorrow. If it rises substantially, will it tell us anything yet as to how long it will remain at elevated levels? Of course we have our own view, where our economists see a continued jobs recovery and stickier inflation ahead, which in turn argues for higher bond yields. But in the meantime a more range-bound market could be warranted, with more technical factors determining the direction such as supply. And there is plenty of that later this week.

The consensus that EUR rates have to come off their still very low levels appears to be broader. There is little data today so the spotlight will fall on ECB speakers and supply. Here the Netherlands will tap its 10Y benchmark for up to €2.5bn. The 30Y green Bund, likely today's business, has added to the near term steepening pressure. And so has the prospect of another sizeable EU SURE related syndicated deal, likely next week.

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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