Rates Spark: Perceptual vigilance

Any disappointment in key US data today is likely to see a larger reaction than a consensus beat. Markets are primed for hints of further deceleration, sentiment already dampened by the spreading delta variant and geopolitics. More concrete hints on the Fed taper will be needed for that bias to shift. Eyes are on the FOMC minutes tomorrow and on Jackson Hole

Source: Shutterstock

Biased towards hints of deceleration

US yields temporarily eyed the upside starting into the week, but that was quickly reversed with a bigger than expected moderation in the US Empire State index. Risk mood had been dampened since the dismal Michigan consumer sentiment reading last Friday, and weaker China data as well as the developments in Afghanistan have only added to the cautious sentiment since then.

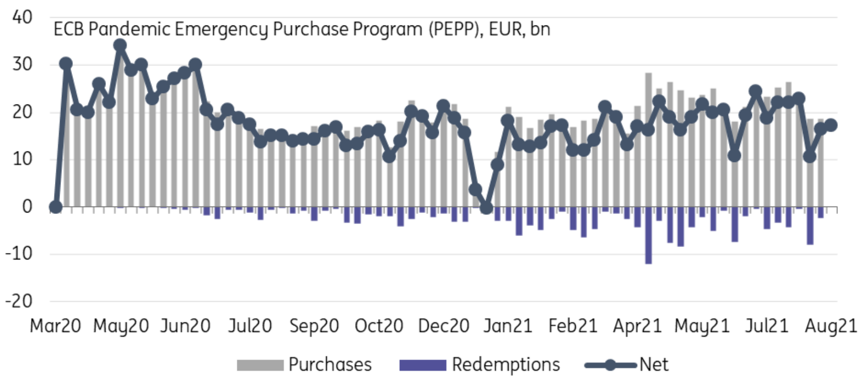
It might look a bit like a case-selective perception by the market. Last week's CPI data showing inflation levelling off likely instilled some confidence in UST longs. But brushed aside are the signs of broadening inflation pressures. Similarly, yesterday's Empire index, beyond the drop in the headline, also saw inflation pressures continue to build with the highest prices-received index value in its 21 year history as our economists have pointed out. Prices-received expectations for six months ahead dipped modestly, but are still the second highest reading of all time.

Through that lens we will probably also have to eye today's data, the US retail sales and industrial production releases, with reaction to disappointments potentially larger than to beats. That could leave the market with bias toward lower rates for now, even with more hints towards tapering possible out of the FOMC meeting minutes already tomorrow evening. Fed Chair Powell does speak already tonight, but an event with educators seems an unlikely occasion for flagging big policy shifts.

EUR see resistance on the downside, but also little upside

In Europe the first impulse was for rates to follow the US lower. EUR rates do enjoy a benign backdrop from the ECB's new strategy that makes hikes seem like distant future and looks set to keep asset purchases in place for some time. But at levels in the 10Y Bund close to -0.5% the room to move lower is limited. In the end 10Y Bund yields moved back above 0.47%, underperforming USTs by more than 2bp and putting the 10Y spread at just below 172bp.

Only moderately slower ECB buying during the holidays



Source: ECB, ING

The ECB has kept the pace of (gross) asset purchases relatively high, considering Europe is in its holiday break. The €17.1bn purchased via PEPP over the past week compares to an average of c.€19bn in April through July. But looming from the end of August is also the prospect of supply activities picking up again. That alone will likely not be enough for EUR rates to keep pace with US rates should they start to rise again - the UST-Bund spread remains directional.

Today's events and market view

The focus is on US data, scoured for any hints of further economic deceleration and leaving the bias for lower rates intact for now. Headline retail sales is seen dropping, but that is likely due to supply related factors in auto sales and also a compositional shift towards services not reflected in the retail sales data. Industrial production should post a decent increase after June's decline, though.

With the spreading delta variant dampens sentiment, more concrete hints of tapering are likely needed before rates eye the upside again. That could come with tomorrow's FOMC meeting minutes, at the latest with a more explicit discussion of the topic at the Jackson Hole symposium later this month. De-linking rate hikes from the taper could give the Fed more leeway to push ahead with the latter. The Fed's Rosengren (non-voting) has been pushing in that direction with his comments yesterday, saying he could back a taper announcement as early as September, but waiting with hikes until further improvement in the job market. De-linking would be a precondition to also see yield curve dynamics (in 5s30s) move towards a steepening bias again.

Elsewhere the UK will see the release of jobs data. In supply Germany sell €6bn in 2Y bonds. The UK sells £2bn in 25Y bonds.

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