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Rates Spark: Getting used to rates on the floor

There may not have been a massive reaction to the FOMC outcome, but we identify the build of an underlying impulse for curve steepening. Further ahead, the US presidential election would likely re-flatten the curve. But the bigger re-steepening event ahead would surround any vaccine unveil (when/if it comes). The BOE is up next; anyone for negative rates?

Federal Reserve

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FOMC post mortem and how the curve should behave ahead

Our assessment of the FOMC outcome is here.

The net effect since has been a moderate rise in long rates and a moderate steepening in the curve. We think this is the correct reaction, and we continue to think that the curve should maintain an underlying steepening impulse.

It was interesting that Chair Powell did not emphasize the Fed's up-rating of the macro forecast profile (higher growth, lower unemployment and higher inflation). Instead, the focus was on the steady profile for the fed funds rates in the coming years. The rationale for this is straightforward – this is what the Fed can control; the Fed can't control the path of the virus and/or the extent of future government support.

We also come out of the meeting feeling that the Fed is comfortable with its policy stance as we head into a key presidential election. It's a steady-state with the Fed offering super-stimulative support for the economy. The fact that things have overall surprised to the upside is positive, as it takes the pressure off the Fed to do more. That pressure falls more on government at this juncture, and the Fed has made that known.

The next FOMC is on 5th November. One big question then will revolve around clarity on the 3rd November election outcome. Even if we were to get some macro-driven re-steepening in the meantime, any consternation around that event has the capacity to spark resumed flows back into the safety of Treasuries. Beyond that, we'd identify a viable vaccine unveiling as a stand-alone re-steepening moment, as it would act to validate any "swoosh" recovery.

Bank of England: laying the groundwork

Hot on the heels of their peers across the pond, the BOE MPC concludes its meeting today. Whilst it is not strictly speaking a 'live' meeting, the Bank's communication could be taken as laying the groundwork for easing in November. To understand why, some context is necessary. Exhibit one is the rising expectations of easing at the next meeting which imply the bar is low for the market's confirmation bias to kick in.

More fundamentally, our economics team sees chances of a deterioration in the BOE's economic assessment. Namely, unemployment could peak higher than its 7.5% forecast, and the time required to make up for output lost since 2019 could be extended by a year. Brexit worries are never far either. The case can be made that, deal or no deal, the economic damage from the end of the transition period would require monetary support.

The last point relates to the BOE's toolbox. QE seems to be the marginal tool of choice judging from recent comments. We think this would be less impactful on GBP rates than endorsing the possibility of negative interest rates, all else being equal. Then again, QE this year does not necessarily rule out rate cuts down the line, especially if Brexit-related risks materialise. Overall, we find downside risks are piling up on GBP rates.

Dutch 4Q funding plans: A case for terming out

The Dutch State Treasury Agency (DSTA) released its 4Q plans yesterday and updated its funding targets for the year. The overall borrowing requirement for 2020 was lowered from €138.8bn to €110.7bn as the GDP decline was less severe as initially feared. Accordingly the money market funding has been reduced, plans for new 12m bills were scrapped and existing lines will be reopened only every other week. The bond market funding target was refined from "minimum €40bn" to "about €45bn" of which €31.3bn has been raised to date.

In line with the DSTA's goal to increase the average maturity of the debt portfolio, the balance is thus shifting towards a higher share of bond funding – this is a trend we expect to become more pronounced for other eurozone issuers as well after the initial ramp-up of bills issuance at the start of the crisis. Other things equal this should add to structural steepening pressure on yield curves.

Looking at the Dutch bond issuance plans for the upcoming quarter in detail, the DSTA has penciled in three auctions: two taps of the 7Y benchmark for €1.5-2.5bn each in October and November, as well as a reopening of a yet-to-be determined bond in November. The launch of the new 30Y bond planned for next week has been confirmed. On 22 September the DSTA will sell the DSL 1/52 with an initial volume target of €4-6bn.

Today's events: EGBs supply, BOE, ECB speakers

Spain (3Y/7Y/20Y/30Y) and France (3Y/6Y/8Y) make up today's EGB supply slate.

In addition to the BOE meeting (preview above), central bank watchers have to contend with another barrage of ECB speakers, featuring Rehn, Guindos, and Muller. Besides Lane positioning himself at the dovish end of the dove-hawk spectrum, recent ECB comments were largely along expected lines. Absent some upward revisions to inflation projections at the last ECB meeting, dovish comments would have had more effect. We reiterate however that money market pricing is already very dovish and that it would take a herculean effort to push front-end rates lower.

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