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Rates Spark: Keep pumping

There was some pre-FOMC meeting talk on a duration extension to QE, but in the end the Fed did the smart thing and kept shtum.This throws a focus on keeping liquidity facilities flowing. No policy steps are anticipated by the BOE. At most we expect it will stress its willingness to intervene should no trade deal be reached between the EU and UK.

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Overnight: optimism lives on

An initially hawkish reaction - perhaps disappointment at the lack of tweak to the Fed's asset purchases (see below) - in US Treasuries was quickly unwound yesterday evening. Despite more supportive comments from various interested parties including, importantly, by Republican senator McConnell, the near-term prospect of a $900bn fiscal stimulus package has not appeared to spook rate markets since yesterday's European session.

The Fed is always there just in case; good to know

Clearly the Federal Reserve is keen to protect the system, extending dollar swap lines and repurchase facilities. These have not been in significant use of late, in fact reflecting the success the Fed has had with securing minimal systemic stress through a series of hand-holding measures for the financial system since the Covid crisis first broke. The fact that the Federal Reserve sees it as necessary to maintain liquidity supportive facilities suggests that they want to take out insurance, just in case things were to get tight in the months ahead.

The quantitative easing underpinning remains as is, so no big surprise there for us. There had been some market talk that the Fed could place a semi-buffer on a rise in long rates through an extension in the duration of purchases. But, the Fed will leave further deliberation on this front until 2021, and the same goes for any mention of the word "tapering".

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The immediate reaction has been a mild test higher in yield and a moderately steeper curve, which seems about right. There is not much in the Fed’s statements that presents a material obstacle to a test of 1% in the 10yr; the only real obstacle is whether the market feels comfortable getting there as we head into a period where seconnd wave Covid-impacted data will likely dip significantly.

That said, markets are tending to look beyond the worst of this, focusing more on reflation ahead. There is enough there to push higher in yield (and steeper in the curve), and to see how it feels up there with a 1-handle in play. Read more on the FOMC outcome here.

BoE: lesser pressure

With a more upbeat Brexit mood music being played since the weekend, pressure on the Bank of England (BOE) to unveil new easing measures has lessened significantly. Our economics team thinks that the monetary policy committee might highlight policy options such as stepping up bond purchases should no trade deal be reached between the EU and UK by the end of the year, but these remain hypothetical. Note also that the BOE extended its asset purchases until the end of 2021 as recently as November, granting it another £150bn of firepower.

There is currently no clear justification to restart corporate bond purchases or to extend the commercial paper programme, given very benign market conditions. Further cuts to the Bank rate, possibly below 0%, are in the same category in our view: possible but only to palliate the economic consequences of leaving the single market without a trade deal. Recent cautious comments on the topic from BOE members also reinforce our view that negative rates are an unlikely policy choice, and that the Bank would only see it as a temporary emergency measure.

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Should events play out as we expect, with a trade deal signed before January 1st, we expect GBP rates to further unwind the risk premium currently baked into them. Taking 10Y Gilts as an example, we think another 10bp can be added by the end of the year, to 0.40%, should a deal be found. In addition, a deal would allow market to price out the possibility of negative rates next year.

Today's events: BoE and Bund issuance outlook

The Bank of England aside, the focus in european government bond markets turns to the Bund issuance outlook for next year. This year bond issuance reached €226bn, and the question is to what degree this will rise given the net new financing needs of close to €180bn pencilled into next year's budget.

Looking at the underperformance of Bunds versus other developed markets and in particular versus swaps yesterday, it appears that some of that could be also be owed to the market anticipating a significantly higher bond issuance volume of up to €280bn. However, much will also depend on the split between short-term money market funding, which was wound down again this quarter, and the longer term bond market. A split of the new financing closer to 50-50 across the two segments would see next year's bond issuance closer to €240bn.

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