Article | 29 January 2021

Rates Spark: It’s all go, on both ends of the curve

Watch the dollar front end. SOFR hit just 3bp yesterday, and easy liquidity conditions could well tempt the Fed into an IOER hike. Just a technical adjustment, and no need for a panic move. But it just shows the extent of "insurance-style" liquidity in the system. Out the curve, a few factors could keep rates low, but expect a more uplifting tone next week.

Source: Shutterstock

Overnight: Game Stop and Go?

Much of the market's attention was grabbed by the back and forth of retail trading platforms banning and then allowing some trades in some stocks characterised by extreme volatility. The tone was overall soft in stock futures amid concerns about repercussions for the wider market through investors deleveraging or through additional regulation of retail trading.

In Tokyo, US Treasuries lingered not far from the bottom of the 1-1.2% range. We're expecting yields to rebound next week (see below) not least because Democrats seem intent on passing their ambitious fiscal plans.

Federal Reserve on watch for potential technical IOER adjustment

SOFR has been edging lower in the past week or so. It hit just 3 basis point yesterday.

The genesis of this is an ample liquidity backdrop, and despite the fact that the Federal Reserve is taking collateral out of the system, the US Treasury is busy adding plenty back through issuance. Moreover, the US Treasury has some $1.7bn of cash sitting on the balance sheet of the Federal Reserve, and as this gets spent in the period ahead, it will make its way into bank reserves, placing downward pressure on general collateral conditions. We noted this as a potential late last year, and it is now beginning to come to fruition.

The issue here for the Federal Reserve really centres on the effective fed funds rate. This is still steady at 8bp. But it could easily be tempted lower given the easing in conditions generally. Ideally, the Fed will want to keep the funds rate well clear of zero. Not just because zero is the bottom of the fed funds range, but also to show it has full control over the funds rate. It is unlikely that T-bills issuance will mop up this extra liquidity, as the US Treasury is on a mission to reduce the size of T-bill outstanding as a percent of overall debt, from (over) 25% currently to the 20% area (it was at 15% pre-Covid).

> *With SOFR at a mere 3bp, an acceleration of a likely IOER hike is on the cards, and it could even be more than 5bp (purely technical though)*

So it will likely be left to the Federal Reserve to make a technical adjustment. The most likely route here is a 5bp (or even a 10bp) hike in the rate it pays on excess reserves. This is currently at 10bp but used to be at 25bp when the Fed last employed a zero to 25bp funds rate range post the financial crisis. The logic of hiking the IOER would be to tempt some liquidity into this bucket and out of the funds rate bucket, thus allowing the effective funds rate to drift higher, or at the very minimum to prevent it from drifting lower.

No mad panic here as this could be left to the next FOMC meeting on 17th March, but at the same time an intra-meeting move, if it happens, would show that the Fed means business, and perhaps that the more recent movements have taken them somewhat by surprise. These are volatile times on both ends of the yield curve, where we get dealt surprises practically on a daily basis. Most important is that the system still works, in a large part thanks to the Fed.

One last hurrah for bonds...

Technicals, in the form of rebalancing out of stocks into bonds, and in the form of maturity extension trades in fixed income, could make for a solid last session of January for safe assets. This should be supported by comparatively weak Q4 GDP growth out of European countries.

That indicator has a habit of being published once markets have moved on to more current themes but the dim growth figures promise a heavy overhang for European economies in the first quarter, to 2021 and compare poorly with the US' positive figure published yesterday.

...and we can see higher rates again

We strategists are sometimes guilty of holding contradicting views depending on the time horizon.

After today, we expect an improvement in market sentiment and a rebound of USD and EUR rates. Still lofty ISMs should prove a boost to morale, and a slight rebound in US job growth before states reopened will at least signal that employment will not have to recover from a lower base when it finally happens.

> *Markets will be inclined to see any swift progress as an encouraging sign for growth*

Next week has also been flagged as a crucial one for the Biden's administration fiscal plan by senate majority leader Chuck Schumer.

Press reports this week suggested that the bipartisan route for any immediate relief bill is still favoured even if it means a watered-down package overall. The hope is that the remaining elements can be passed later through the budget reconciliation process.

With this in mind, we think markets will be inclined to see any swift progress as an encouraging sign for growth.

Today's events and market view

Of the French, German, and Spanish Q4 GDP released today, only the German stands a chance of eking positive growth. Besides the positive surprise in the French measures already published this morning, we expect these will make for painful reading after the US figure yesterday.

US data consists of a final reading of the University of Michigan consumer sentiment, hardly market moving in our opinion. Personal income and spending will be the other two releases to watch.

> *We doubt 10Y USD rates will dip much below 1% today*

Barring another leg lower in stocks, we doubt 10-year USD rates will dip much below 1% today and if they do, we expect the move to be retraced next week. In Europe, the long-end appears most at risk of an adjustment higher in rates, after the ECB talked up the odds of further cuts.

Authors

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com