Rates Spark: Reopening angst

Financial markets are not immune to reopening angst. Fear of overheating and of excessive leverage are factors behind the recent souring in risk aversion. This does not change the macro story in our view, and PMIs/ISMs today should be a reminder of that.

Source: Shutterstock

How hot is too hot?

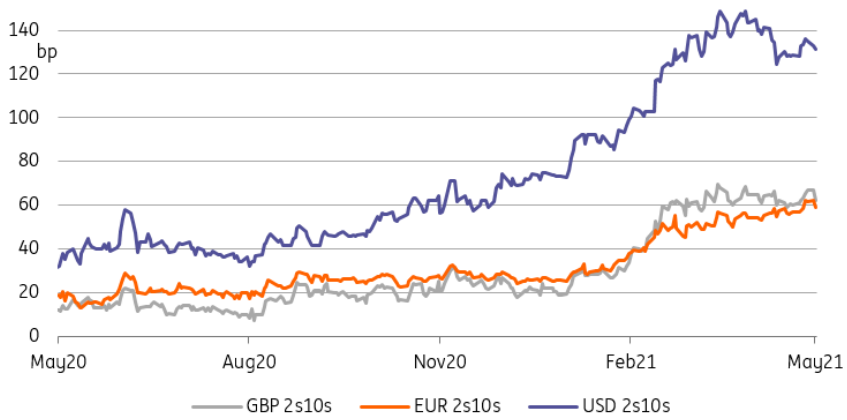
An update on rate markets has to include an attempt at explaining of the recent souring of market sentiment, most prominently yesterday. There is more than one possible explanation but we suspect markets are suffering from a version of the reopening angst that many workers will feel when asked to return to their offices.

Even if data went through a period of slower improvement in economic activity, PMIs/ISM and other diffusion indices printing in the 60's can hardly be considered bad news. This is particularly true as each successive elevated reading reduces the probability that comparison with depressed levels boosted the indicator. More broadly, economic data of late seem to have confirmed that the recovery in some corners of the world, for instance in the US and Europe, is picking up pace. Job indicators this week should be another confirmation of that.

The recent surge in prices and capacity constraints might act as a break on activity

Without going through the specificities of each sector of the economy, it is conceivable that too sharp an adjustment higher in economic activity sows the seed of its own abrupt end. Take commodities or chip shortages for instance, the recent surge in prices and capacity constraints might act as a break on activity on key sectors of the economy. One does not have to expect an abrupt tightening of monetary policy to see how this could adversely affect risk appetite.

Risk aversion has flattened yield curves this week



Source: Refinitiv, ING

Financial markets return to the office, with some rebalancing required

There is also a financial aspect to this argument. As valuations of some sectors ran ahead of expectations in the immediate aftermath of the Covid-19 pandemic outbreak in early 2020, the widening recovery and sector rebalancing might also bring doubt about sustainability of these valuations. Add to this worries about excessive leverage and it is understandable that financial markets feel twitchy.

More rates volatility is to be expected as they rise from record lows

This is far from our central scenario but the interest rates impact should be fairly straightforward, should such risk aversion persist. Demand for safe havens should drive US Treasury and Bund yields lower. The impact should be greater at the longer end of the curve if investors are prone to draw persistent economic or monetary policy conclusions from it. At this stage, we find it a stretch to base our macro rates view on it. On the contrary, reopening still appears a tailwind to sentiment, even if more rates volatility is to be expected as they rise from record lows.

Today's events and market view

Of the services PMIs/ISMs today, only the Spanish, Italian, and US ones will be first readings. In addition to the ADP, the employment component of the US ISM will help shape expectations for Friday's job report. Economic data seems to have taken a back seat as a driver of price action, but we feel more comfortable aligning our near-term rate expectation with our medium term macro view: the recovery requires higher EUR and USD rates. Treasury secretary Janet Yellen's remarks that higher rates might be needed to prevent overheating is one reminder of this basic economic truth, even if she didnt mean to send a near-term policy singal.

Germany selling 5Y debt is the sole Euro sovereign auction on the calendar, but Greece mandated banks for the sale of a 5Y bond via syndication which we expect will take place today. The UK debt management office will also sell 10Y and 25Y debt as tomorrow's BoE meeting could put the spotlight on its tightening strategy.

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