Rates Spark: Save the taper

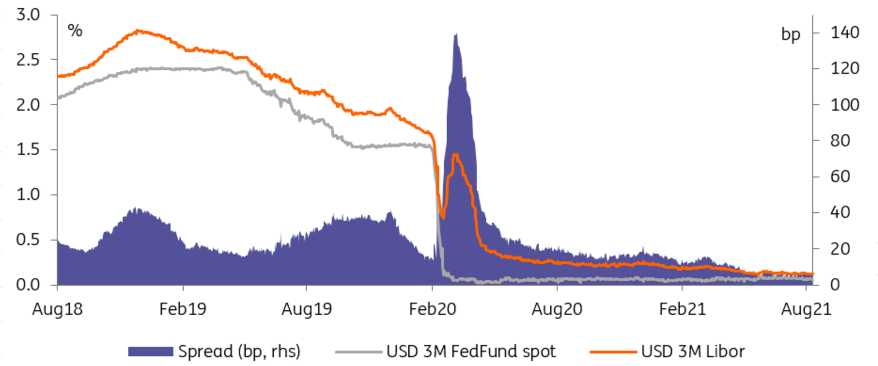
The fate of a September tapering announcement hangs by a thread. Only a bumper payroll number today can save it. Markets are increasingly pessimistic. But it helps to keep system risk remarkably (and probably anomalously) low. The coming weeks will see a spike in issuance that skews rates higher and means a post-payroll rally is likely to be sold into

System risk is on the floor, which is a risk in itself

We discuss here the notion that this marketplace is not attaching much value to the price of risk.

The simplest example is the 3-month USD Libor at below 12bp, practically at a record low, and with a record low bank spread element. This is a reflection of the comfort blanket of liquidity that has enveloped the marketplace. While this is comforting and leads to exceptional funding conditions, it also poses risks as the taper actually takes hold when it does. That process does not need to be a drama, and likely won't be, but at some point, risk will have to be priced more appropriately, and getting from here to there is likely to be painful (total returns painful, that is, for fixed income).

Tapering and the end of the debt ceilling drama should push Libor back up



Source: Refinitiv, ING

A dovish Powell and deterioration in economic data is priced in...

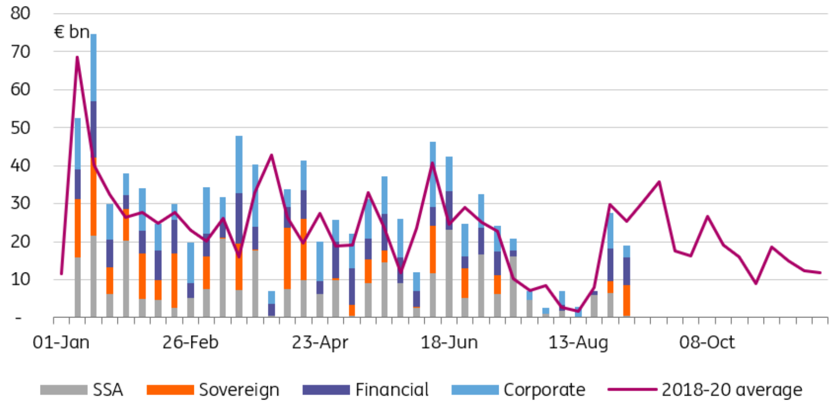
Fed chair Jerome Powell's cautious tone and the continued decline in US economic surprises are well accepted facts.

So much so that we doubt their relevance in driving future moves in US Treasury yields. As we have discussed, the divergence between USD and EUR rates this week is striking, and a sign that investors have largely priced out the odds of a September tapering announcement. In addition to Powell's dovish communication at Jackson Hole, we think a key reason is that expectations for today's payroll number has been pared back.

> *The risk scenario is one where a high payroll figure forces the market to rethink the odds of tapering*

Raphael Bostic from the Atlanta Fed flagged that he would need to see 750k job created in today's report, higher than our 625k forecast, to favour tapering at this month's meeting. Given that he has recently sat at the more hawkish end of the FOMC, we suspect the bar is even higher for his peers. The base case is thus for a muted reaction to a soft(ish) number today, but the risk scenario is one where a high payroll figure forces the market to rethink the odds of tapering. Unlikely, but potentially impactful.

EUR syndicated supply is back with a bang, at least until October



Source: Bond Radar, ING

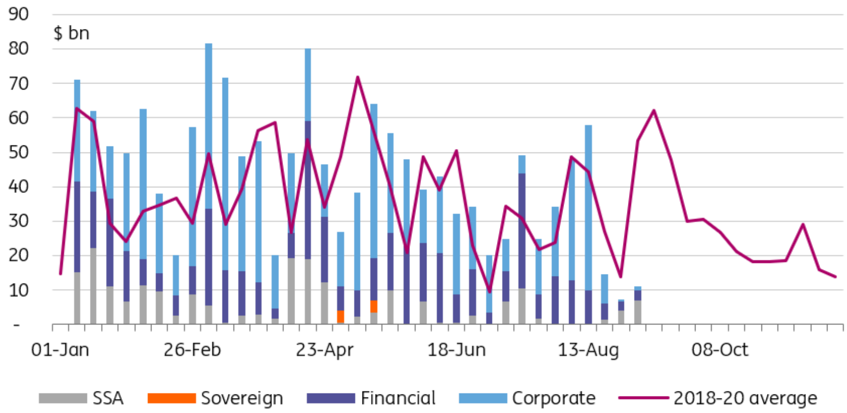
…so let's look at supply

Even in the case of a soft payroll number, we see a case for rates ending the session higher.

Seasonality of supply means that the coming weeks are likely to see a flurry of syndicated deals. Both in USD and EUR, there is a well-defined tendency for borrowers to return to primary markets at the end of the summer. That September spike was more pronounced in recent years for USD markets, while EUR issuance was more evenly spread between September and October.

In both cases, it will be a challenge for bond valuations that are more expensive than before the summer.

USD not yet, but beware of the September spike



Source: Bond Radar, ING

As US markets look forward to a holiday-shortened week due to Labor day, the time to lock in rates through hedges is limited. This makes the upcoming spike in issuance potentially more impactful in our view, especially since the past two weeks' total have run well below the average of the previous three years. Even if we are wrong in suggesting that some catch up in the volume is overdue, the combination of syndicated supply and US Treasury auctions skews rates higher next week.

Today's events and market view

The economic build-up to the US jobs report this afternoon will be a busy one. The European morning will see the publication of the final PMI services. The Dutch, Spanish, and Italian numbers will be the first releases, while the others just an update on the preliminary reports from late August. In the Eurozone-wide measure, the service sector has remained resilient in the face of a resurgence in Covid-19 cases, while supply chain disruptions significantly affected the manufacturing index.

Our economics team has a sub-consensus estimate for today's US payrolls of 625k, compared to 725k for Bloomberg's survey. We think expectations have progressively been scaled back into today's release, so the ability of a low number to move the market is impaired in our view. What's more, we suspect any rally will be sold into to prepare for next week's raft of long-end Treasury supply and corporate issuance (See above).

Markets will be kept on their toes after the jobs report as the afternoon also brings the August ISM services report.

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