Rates Spark: Setting a course for change

The key theme from the Fed's minutes was preparedness, including a key discussion on the premanent repo facility, which in fact looks beyond the taper. But market rates need to be higher beyond the taper too, or this Fed won't be in a position to do much hiking at all.

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So what did the Fed have to say about market rates? Not much, but there's an issue

With respect to the fall in market yields, the Fed notes policy communication, investor positioning and the pandemic as driving factors. There was no particular role noted for the macro economy, or any data impact. Rather the Fed preferred to focus on the technical explanation of a fall in the term premium reflecting the above-mentioned factors. There was not much more discussion beyond that on why rates are where they are or to what extent they signal anything if at all.

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What will be a factor ahead is the need for higher market yields so that the Fed has room to ultimately hike rates in the coming years. This is not for the here and now, but it is something that will be on the radar once the taper is complete, which on our interpretation of events would be around the middle of next year. So, to facilitate that, we argue that there needs to be a tantrum. If the Fed has a taper announcement and/or taper and there is no tantrum at all, that in fact is a problem for the Fed. The Fed may not have said it, but they will be aware that this is an issue.

The new permanent repo facility and what it prepares us for

The Fed minutes contained some interesting discussion on the Fed's permanent repo facility. This is a new facility, one that effectively allows the market to generate reserves by posting collateral at the Fed. In simplistic terms it makes bonds equal to cash for eligible counterparties, which is significant. It's not relevant for the here-and-now of course, as the market is long reserves and short collateral - hence the USD 1trn of excess cash going back to the Fed on on a daily basis on the reverse repo facility.

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In contrast the permanent repo facility will allow the market to post excess collateral (or just collateral) for cash. This will become more important when the Fed completes its tapering process, and really becomes relevant should the Fed decide to take reserves out of the system by lowering it's holdings of bonds (whether slow grind: not re-investing in roll-offs, or fast track: actual bond sales).

There was some discussion around the USD 500bn limit to the facility, and whether such a cap was necessary. The was also a counterparty limit set at USD 60bn, but there was less discussion on this. There was general support for the facility, although one member would have preferred access to foreign players to be made available during periods of market stress, rather than through a standing facility.

Ultimately the permanent repo facility should help to make for a less spiky market for short term rates, allowing the Fed more control over the repo market, or in a sense provide the market with the means to control it independently.

Today's events and market view

Following the FOMC minutes we now await the Jackson Hole symposium next week to hear more on the looming taper. A September taper announcment looks possible, but the minutes itself have signalled no agreement yet on timing by officials. It is the more recent officials' comments that lean towards an earlier start (for a detailed discussion see also here).

Should coming days also confirm the levelling-off of virus case numbers we are currently seeing in the US areas hardest hit earlier in the summer, this would allow a clearer refocus on the taper and open more upside in US rates. Tentatively that was already happening with the 10Y UST-Bund having widened 2.5bp yesterday before a dip in risk sentiment pushed UST yields lower again.

In data today we will get the Philadelphia Fed index as well as the weekly initial jobless claims. In European primary bond markets France sell off-the-run bonds from 3- to 6-years maturity (€6-7bn) and inflation linked bonds (€0.5-1bn). In all nothing to move the needle in a meaningful way, but French bonds' spread perfromance has lagged relative to their peripheral peers over the past weeks.

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