Rates Spark: Some progress, more needed

A hawkish shift is underway at the Fed, with tapering getting closer and the prospect of persistent inflation getting a nod. Market reaction was more muted than after the June meeting but bonds remain sceptical of any hawkish shift..

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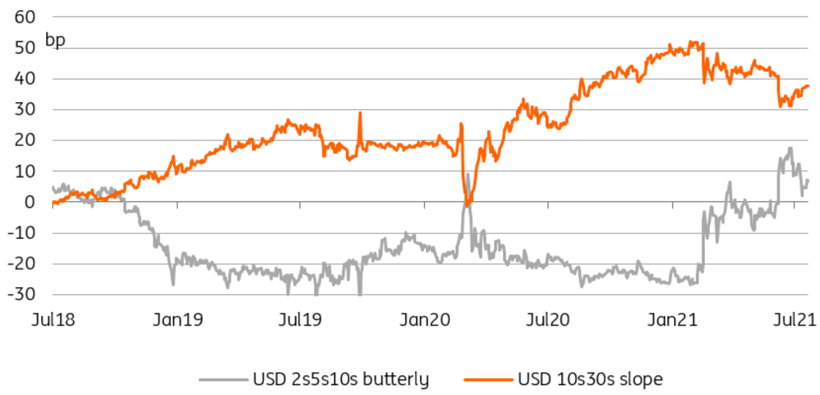
A more hawkish message

The Fed at its July meeting noted the economy made some progress towards the goal it would like to reach before tapering asset purchases but, in the words of chairman Jerome Powell, we're still some way away. Clearly the debate on when and how to reduce QE from $120bn/month to zero is heating up but we are not expecting any formal announcement before December. Still the press conference provided some clues. The Fed seems to have ruled out tapering mortgage backed securities first, but the reduction in purchases could be faster than that of treasuries.

Rates have reacted with scepticism to hawkish Fed communication



Source: Refinitiv, ING

High inflation is still judged to be transitory, but Powell noted upside risks

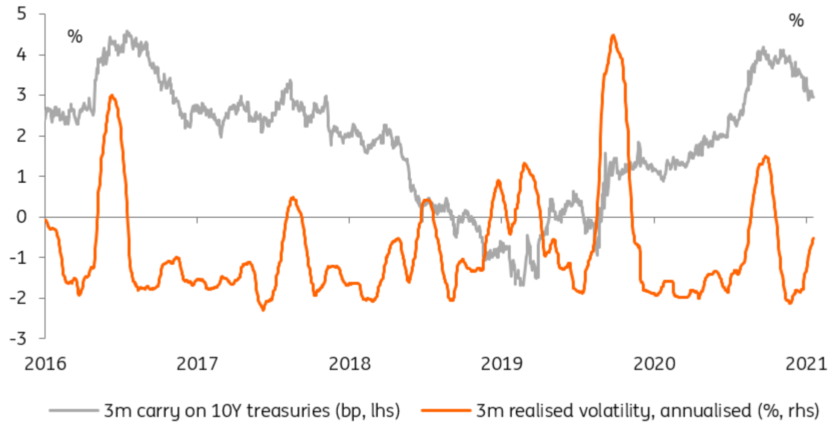
Other less dovish than expected statements were regarding inflation and the current Covid19 wave. High inflation is still judged to be transitory, but Powell noted upside risks. The resurgence of Covid19 cases calls for some caution but there seemed to be no consensus on its economic impact yet. Overall a fairly balanced communication exercise but consistent, in our view, with the Fed's hiking cycle starting in 2022.

Some glimmers of hopes

The unanswered question is now where are rates headed. Hawkish or not, the Fed does not dictate the market's state of mind or the macro outlook. We do not share the pessimism expressed in low rates, if it is indeed what they are expressing, we are more sceptical that the message should be taken at face value. Be it as it may, it will take time to lift the current gloom pervading among investors. Strong data would help, for instance a beat in the Q2 US GDP to be released today.

A continued drop in Covid19 cases as is seen in the UK or the Netherlands would also carry hope that the wave playing out in other countries stands a chance of being short-lived. Data is tentative so far but markets are forward looking and do not wait for complete information to price future events. If there is a driver for higher rates in the coming days and week, we think this is the most likely.

The case for owning treasuries is weak, but reversal might have to wait



Source: Refinitiv, ING

Technical factors have proven very supportive to lower rates

Even if causes for optimism are real, they have to be weighed against technical factors that have proven very supportive to lower rates so far this summer. Low supply and central bank purchases probably magnified the downdraft in rates in July and we are not expecting a change in this state of play until much closer to September. With a more near-term horizon in mind, the approaching month-end deadline tend to prove supportive for curve flatteners, but this should fade next week.

Today's events and market view

Today bring the first instalment of Eurozone state CPIs for July, from Spain and Germany. The jump in the German index, owing in part to VAT effects, could unnerve the market. The Eurozone-wide measure, to be released tomorrow, should only edge moderately higher. Besides a short-term drop in yields, we actually doubt this release will have a durable impact. Granted, a debate a raging about how transient inflation will turn out to be but the ECB's new forward guidance has shielded markets from too hawkish a reaction. Asset purchases are still to be addressed at the September meeting, so if there is any lasting impact, it should be a steeper curve.

Italy will auction 5Y/10Y and inflation-linked bonds today.

Our economics team expects an above-consensus 9.5% US GDP growth in Q2, while jobless claims will be closely watched after an unexpected rise last week.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

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