Rates Spark: Follow the taper trail

US inflation is solidly rounding at 5%. Bond yields are nowhere near that, and some $800bn is getting shipped back to the Fed on a daily basis (overnight). "Forget the taper, just stop the buying already" – that's what the bond market would say, if it could talk. Chair Jay Powell will do the talking today, and the bond market will respond in kind

Fed Chair, Jerome Powell

Double whammy - poor 30yr auction follows high inflation reading

There has been a bit of a recalibration at the back end of the US after yesterday's 30yr auction – which was poor. The cover was there only as primary dealers were roped in to cover it, and it tailed. The high of 2% was the headline, some 2bp higher than where it traded before the auction. The key thing has been the follow-on move that has seen the 30yr trek up to 2.04%, bringing the 10yr with it as it has broken back above 1.4%.

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The elevated inflation print yesterday (now 4.5% core!) was not a direct influence, but was likely an indirect one, leading to a bit of indigestion after decent 3yr and 10yr auctions yesterday. We don't read this as a "weight of supply" issue, as this flies in the face of the lack of collateral afflicting the front end. But it is certainly a reset moment, where the relentless ease lower in longer-dated yields has at least been thrown into question.

Could be an important moment, this.

Over to Chair Powell now to help bring it all together

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If we look at the bond market alone, what do we see? A few things. First the bond market is yelling at the Fed to taper already. In fact it's saying, forget the taper, just stop buying. The back end of the curve is trading at levels that are so deviant from where inflation is that it risks being a problem for the Fed. If the Fed were to start hiking today it would have a problem, as after a couple of hikes they could well risk inverting the curve (as long end rates would be more likely to fall than rise in their current mood).

The Fed of course is not ready to actually hike rates. The economy is still not where it needs to be. More healing on the labour market is required first. But also, to be in a position to actually hike, ideally long rates should be far higher than they currently are. A swift taper can help bring this about. A mild taper likely won't, as that is the baseline expectation. If Chair Powell wants to affect the market, then a nod towards a swift taper would be the way to go.

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The front end of the curve is screaming the same. There is some $800bn going back to the Fed on a daily basis at its overnight window, and this is liquidity that is simply getting parked, and parked at just 5bp. Stopping the addition of liquidity from Fed buying could at least take some of the downward pressure off front end rates. One complication here is the looming debt ceiling, which makes it difficult for the Treasury to help mop up the liquidity excess. But that is something that the Fed does not have control over.

The combination of yesterday's high inflation reading, followed by a poor 30yr auction and now today with Powell in a position to opine on things; we could be on the verge of some key soundings for the market.

Today's events and market view

While US PPI data will be scrutinised for signs of abating pipeline pressure for inflation, all eyes will turn to Fed Chair Powell's testimony to Congress after the blowout CPI release yesterday. Our economists look to today and the Jackson Hole conference in August for hints of an upcoming taper which they believe could start in 4Q this year. Long end rates seem unfazed by the prospect for now and it took a weak 30Y auction yesterday to push rates higher.

In the eurozone, ECB speakers have their last opportunity ahead of the pre-meeting quiet period to fine tune market expectations. The stakes for next week's meeting were raised by Christine Lagarde, who signalled changes on the back of the recent strategy review. Hence, markets will pay close attention to the ECB's Isabel Schnabel when she talks about the challenges of the low interest rate era today. In the end, those are already well known and it is hard to see how the ECB could realistically impress markets.

EUR rates also have more supply to digest, with Germany tapping the 10Y for €4bn and Portugal in the market tapping 10Y and 15Y for up to €1bn.

Authors

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

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

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