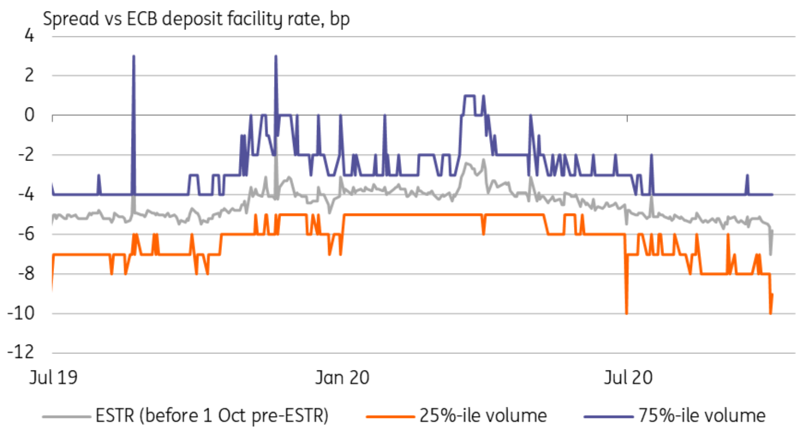
Article | 2 October 2020

Rates Spark: Can't catch a break

A wider spread between US and Euro market rates has emerged of late. Macro angst continues to dominate in the Eurozone, while US data has had a tendancy to be better than expected (and more fiscal stimulus seems close). Core Euro rates have deflation as an anchor, while the US is closer to worrying about supply. Something must give; payrolls could decide it.



Source: ECB, ING

EUR rates are pointing lower, core to benefit first

Given the dismal CPI readings across Eurozone member states earlier in the week, it is fair to say that market expectations going into the Eurozone-wide measure are lower than the survey. If the room for the headline number to surprise is limited, we think another dip in core would be more difficult for markets to shrug off, especially at a time the ECB has emphasised its relevance in monetary policy decisions.

The stage is set, in our view, for a gradual grind lower in core EUR rates, (by which we mean core bond yields and swap rates). In the near term, safe assets should benefit from the uncertainty surrounding the EU recovery fund timetable ratification, and the ECB's preferred easing tool. This should allow core rates to foray into deeply negative territories that they haven't reached since March.

Longer term, we think the EU recovery fund will get ratified and our economics teams thinks that the ECB's preferred easing tool will be to increase QE. Both should be beneficial for spreads with higher-beta sovereign able to catch up to core gains after the current period of uncertainty. For now, we feel there are enough threats to sentiment that investors will express bullish fixed income views in core.

USD rates are showing an upside test bias though

Where overall rates remain is a strong function of what happens in the US. Rises in core market rates in the past couple of days have clearly been driven from the US, as evidenced by the widening in the Treasury-Bund spread. The theme in recent days has centred on some end-month core bond selling as portfolios were re-balanced, added to some paring in duration longs.

On top of that the US data releases, while not pretty in absolute terms, have tended to beat expectations - we saw another example of that in yesterday's inflation data in particular. The expectation is that Friday's payrolls report could also be higher than expected. On the one hand that rationalises a test higher in market rates, but on the other it leaves market rates vulnerable to downside pressure should pre-payrolls hopes prove misplaced.

The other known unknown centres around potential passage of a stimulus package through congress. It feels like this is getting quite close, as it seems it benefits neither side for it not to get done. Passage would leave the bond market open to discount added supply. Lots of moving parts as we head to the weekend. This curve will eventually steepen out. But it needs to navigate US presidential elections and ongoing Covid angst, which seems to amplify everything right now.

Money markets: €STR bounces from month-end low, but everything points to increasing pressure

The €STR overnight fixing bounced back from its record low, only to fix at its second lowest level in its still brief histrory. We had already suspected that the dip to -0.57% was related to the quarter-end, but potentially aggravated by that fact that the €174bn from the ECB's latest targeted long term operation (TLTRO III) also settled on that day. This liquidity injection has also pushed excess reserves in the banking system over the €3tn threshold for the first time.

The rate at the 25-percentile volume had already seen a similar dip at the end of June but the trimmed mean measure (used for the fixing) did not move as much back then. That said, the 25-percentile measure has started to be consistently lower since the middle of August, which indicates that what has been pushing Euribor fixings lower is also impacting the market underlying €STR (to a much smaller degree): We expect that banks flooded with liquidity, especially on quarter ends, are not particularly keen to show large balance sheets thus pricing o/n wholesale deposit more defensive. The 3m Euribor fixing itself might well slip below the ECB's 0.5% deposit facility rate again.

The past quarter-end does cast a shadow ahead onto the year-end, where the situation could become even more acute as banks also have to take into consideration balance sheet charges from the bank levies for instance. It could also put the fixing methodologies to the test, with contingencies potentially triggered.

Today's events: Eurozone inflation, US payroll

There is a busy economic agenda today. In the Eurozone, the highlight is the September CPI and core CPI releases.

In the US, the September job report will be closely watched. Our US eocnomist see risk of a slowdown in payroll growth. University of Michigan and durable good orders are final releases so less market-moving.

Authors

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

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

Disclaimer