Rates Spark: The after party

Bonds are not just reacting to risk assets, they are setting out their own stall. Rates are rising for reflation reasons, but we also show why the rise should be muted. We see little to stop the momentum today. Supply weighs, but is a technical and temporary factor. The next big directional impulse will come from US payrolls on Friday.

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Overnight: Vaccine week and Draghi’s return

Stocks futures maintained this week’s gains in Asian hours and bond futures traded at close to the highest implied yield since mid-January (corresponding to the famed 1.11% resistance for 10Y US Treasuries). Optimism surrounding what is now shaping out to be vaccine week still abounds after a number of studies confirmed various jobs’ efficacy. For instance, a study confirmed that the AstraZeneca vaccine maintains its efficacy in case of a longer period of time between the two shots, thus vindicating the inoculation strategy adopted by countries like the
UK.

There is nothing Italian bonds dislike more than political instability

In Italy, as coalition talks with centre left parties failed to produce a viable compromise, president Mattarella is due to meet Draghi to attempt to form a technocratic government. We understand the knee-jerk rally in Italian bonds as a result owes to a large part to the former ECB president's name being associated with lower yields. However, his success, and therefore the sustainability of this rally depends on a broad agreement among political parties on the government's agenda. M5S, the largest party in parliament already said it opposes the idea. As a result, the benefit of a safe pair of hand has to be weighed against the stability of a new technocratic administration, for there is nothing Italian bonds dislike more than political instability.

US rates are on the rise, but very much thinking independently

The hold at 1% last week for the US 10yr has been critical. It has quickly seen the focus switch to 1.1%. That area for now is a haven, well above 1%, but also below the 1.2% area that was not broken to the upside some weeks back. There is still a net reflation theme in play. Provided we hold on to a 1-handle, that should remain the case. And the target ahead is still the 1.5% area, and when we get there we are still looking up rather than down.

"There is still a net reflation theme in play."

There is one important nuance to this however - this is still not a "bear market for bonds". That may seem like a strange statement to make, as we are anticipating higher market rates. But there is a key twist here, as we are not expecting a fast uplift in market rates. Instead we see it as a measured and steady rise, especially as the back end must do the bulk of the heavy lifting, against an anchored front end - steepening from the back end is much tougher than from the front end.

Support for this comes from the structure of the curve, which has only seen the 5yr become even more rich relative to other maturities. This is critical, as a very rich 5yr area is typically a bull market signal for bonds. Here it gels with a Fed that is still very much in easing mode. And it applies a brake on ambitions for big increases in market rates. Moderate ones are fine. It also helps explain why market rates don't tend to rocket higher when we are in risk-on territory.

EUR rates unfazed by the jump in inflation, but supply still weighs for now

In Europe he currently higher inflation prints themselves do not appear to concern markets (and ECB officials who vowed to look through them). The added upward pressure on rates from the supply side is intact. After yesterday's 50Y Belgian deal and 30Y Finnish bond, Portugal takes its turn with the placement of a new 30Y bond. Tomorrow then sees long end bond auctions from France, after which we see room for a relief rally in EUR rates and at least the steepening pressure on the 10s30s curve to subside.

A peek at intra eurozone government bond spreads suggests a somewhat murkier picture for risk sentiment yesterday. The flurry of supply is likely to play a more technical part here. Italy
may be the other source of market caution as government formation talks are not going as quickly as some may have hoped. In the end it may be worth the wait. The 10Y Italy/Germany spread was the underperformer yesterday, but the prospect of a PM Draghi could be the best outcome for markets. We still have a 90bp target for the 10Y spread.

**Sector allocation of French ultra-long deals**

![Sector allocation chart](image)

Source: AFT, ING

The long end issuance by governments is also satisfying investor demand for yield pick-up

The steepening should eventually be dampened as the long end issuance by governments is also satisfying investor demand for yield pick-up. Looking beyond sheer order book sizes which have grown to record levels, the allocation statistics also suggests a growing demand from pension funds and insurers. As central banks keep interest rates under wraps the sectors’ hedging demands increase.
Today’s events and market view

While yield levels are starting to look lofty for the 10Y Bund above -0.5% we think relief has to wait until this week's long end supply is put out of the way – tomorrow's long-end French auctions loom large and typically relief follows. Today still sees a 30Y deal from Portugal, yet probably more relevant for spreads than outright valuations.

The EUR preliminary inflation data will grab the headlines, but the technical factors have all been well flagged and following the country prints a jump higher is a foregone conclusion. We will also get the final PMI readings including first readings for Italy and Spain.

Main focus should be on the US session with ADP private payroll data ahead of the official jobs report on Friday. Markets are eyeing a modestly positive payrolls report in January after the December drop. The January ISM services is seen coming in weaker with the sector bearing the brunt on the Covid containment measures. Manufacturing had disappointed earlier this week, but similarly the level itself should still indicate resilience of the US economy. Markets will also look to the Treasury’s refunding announcement.
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