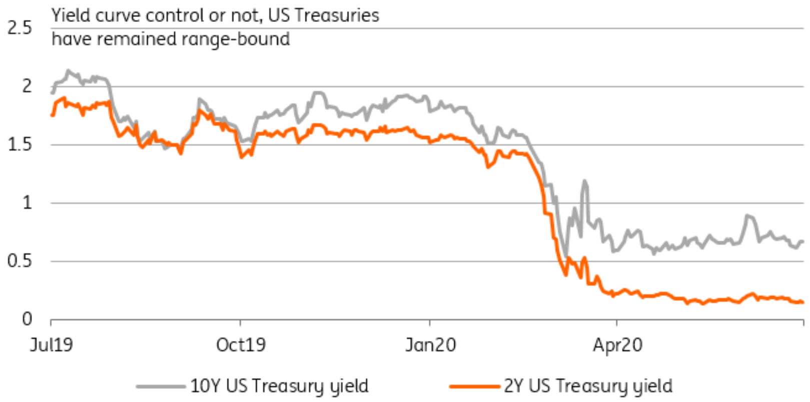
Rates Spark: The path to lower rates

Don't take the Fed's decision not to go down the route of yield curve control as evidence of confidence in the economy. The thing is, it's just not needed right now. The curve is where it is because it wants to be there. And that's not a pretty outcome as an implied discount for the economy.



Source: Bloomberg, ING

The Federal Reserve is unwaveringly concerned - but no yield curve control on the horizon

A combination of Fed minutes and spokesperson comments has made clear in the past 24 hours that the Fed is far more concerned about prospects for the US economy than the stock market is. Bullard was the latest central banker to warn about the ongoing risk of a financial crisis, and against a premature withdrawal of easing measures in place to prevent it. Talk of a 4yr recovery path, even on a successful virus vaccine discovery scenario, gives us an insight into this. And by the way, the USD IRS curve reflects this, as the 4yr swap rate trades through the 3mth Libor rate. In fact the 3yr swap rate is through the fed funds rate ceiling at 25bp.

The Fed has also ruled out yield curve control for now. We agree; see our recent note here. Some have argued that market rates have been held down by the prospect of the Fed being about to unleash yield curve control. We are less convinced by this argument. The odds of the Fed going down that route have not been convincing in the past couple of months. The curve is where it is as a basic market discount, and not there on moral coercion; although granted that recent Fed buying has contributed to low rates. So has the prospect of more explicit forward guidance which seems to be gaining traction among members, although its final design remains to be ironed out.

Longer yields did edge higher yesterday. But that was more a reflection of tighter credit spreads and a tint of risk-on. Reverse that and we will be back to where we started very quickly. Our medium-term view does see an eventual move into the 75-100bp range for the 10yr, but this is more a post summer move, and really needs better health news for it to come to fruition. In the meantime, the range is 54bp (all-time low) to 70bp, and the possibility of taking aim at that prior low is not over yet.

A temporary blip in the middle of a downtrend

It will come as no surprise that we find it hard to subscribe to the relief rally (for risk assets) / sell-off (for safe havens) taking hold of markets this week. The most significant leading indicator in our view is that more measures are being announced to prevent the coronavirus from regaining footholds in various jurisdictions that have so far recorded successes in bringing down the number of cases. What's more, we are also sceptical about the reliability of the signal sent by survey indicators such as the ISMs and PMIs.

As we have warned in yesterday's Spark, we regard the jump in interest rates as a temporary blip in the middle of a downtrend. A re-test of the -0.50% level for 10Y Bund, and -0.20% for 10Y EUR swaps, is a possibility in the run-up to the July ECB meeting in our view. Admittedly, the US jobs report, brought forward by one day due to the US July 4th holiday, is a wildcard. Our view is that the period after the twin Spanish and French auctions (see details below) should be more favourable for duration, if nothing else due to short covering after the move this week.

Overnight, the ECB's Rehn spoke against explicit yield targets, echoing similar comments from Lane yesterday. This is all a matter of wording in our view. In recent speeches, the same Philip Lane said a key target of PEPP was to lower the yields on European government bonds (as measured by the GDP-weighted 10Y yields). There may not be an explicit target for individual countries but it is fair to conclude that average yields should remain below pre-PEPP levels for the program to be successful.

Today's events: US Jobs, Spanish and French supply

Spain (5Y/7Y/10Y/10Y linker) and France (15Y/20Y green bond/30Y) sell debt this morning. In the afternoon, look out for a batch of US data including jobs numbers and factory orders.

Meanwhile the flurry of ECB comment will continue with Mersch and Schnabel. Officials are currently treading a fine line between acknowledging the improvement in economic data, and preventing an unwind of the improvement in market conditions central bank easing has allowed.

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