Rates Spark: the skew into US jobs

We think a slowdown in US job creation is already priced in. Expect higher USD rates as the market sets up for next week's supply. Positioning and the proximity of a consensus-beating ECB package should keep EUR rates in check. We detail our expectations.

Source: iStock

Overnight: political noises

The tone of overnight reports about Brexit negotiations was fairly downbeat on balance, saying in essence that odds of an imminent deal are dim. This being said, with the end of the year approaching fast, urgency has stepped up a notch and it is still possible that a deal materialises in the coming days.

There was more optimism in the other pressing political issue the EU is facing, the recovery fund. Poland expressed a willingness to drop its veto on the union's budget and emergency fund. Hungary's Orban on the other hand seemed to reject the proposed Polish compromise.

In both cases, an agreement would be a near-term threat to our view that EUR rates will remain contained but we do not expect any sell-off to be long-lasting.

Stateside, the barrage of warm words continued with McConnel and Pelosi both expressing support for a stimulus package, albeit a limited one in the case of the Republican leader.

Bond futures in Asian hours remain close to yesterday's highs. Confusion about a cut (already announced earlier last month) in Pfizer's vaccine delivery target weighed on sentiment late in yesterday's session but stock futures have been on the mend since, which in turn is starting to weigh on bonds at the European open.

US jobs: skew higher in rates

Today's main event is the release of the November US jobs report. Hope is it will bring a tentative answer to the question of how much economic disruption is the second (or third depending on how you count) covid wave causing. What is generally accepted is that job growth is decelerating into the end of the year, and that more weakness could be on the cards as states impose restrictions. This near term gloom is balanced by medium term optimism in our view, which is preventing USD rates from dipping much lower in the interval.

> *Technical drivers also conspire to support elevated USD rates*

With a shorter timeframe in mind, technical drivers also conspire to support elevated USD rates. We expect the immediate aftermath of the jobs report to be dominated by positioning into next week's 3Y/10Y/30Y US Treasury auctions. This we think skews the odds in favour of any UST rally to be faded even in case of a weak jobs report. Our conviction is reinforced by the fact that consensus for today's job numbers has already been adjusted down, indicating fairly low expectations.

ECB to out-dove the market next week

Price action so far this week has proved that the USD-EUR rate widening theme is valid in sell-offs, and perhaps more surprisingly in rallies. It provides a template, we think, for the way rates markets will trade in the run up to the new year. When rates sell off (rise), we expect both EUR rates to rise with their USD counterparts, although to a lesser extent. This is what happened on Tuesday and Wednesday. When price action stabilises, as was the case yesterday, then EUR rates should drop faster than USD.

A risk to this view would be in case of profit-taking into the ECB meeting, but we think this risk is manageable. The latest Bloomberg survey suggests that market expectations for a €500bn extension of PEPP have not changed since October, but it is the TLTRO and the APP in particular where the ECB still has room to surprise markets on the generous side. Indeed, our economics team expects a consensus-beating package comprising:

- A €500bn increase to the PEPP asset purchase target, and an extension in time until at least end-2021
- An extension of the attractive interest rate period on the ECB's loans to bank (TLTRO), as well as additional liquidty allotments in 2021.
- A doubling in the monthly pace of APP asset purchases to €40bn

This should be enough to deter significant positioning in favour of higher EUR rates. Additionally, we doubt there has been much bullish positioning to unwind into this meeting. In our view, if there were weak longs they would have been flushed out in Tuesday's sell-off.

Today's events: US employment

In addition to the jobs report, other US releases include factory orders.

There isn't much else to signal.

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