Rates Spark: The summer of (carry) love

Covid-19 worries and a dovish ECB make for a supportive backdrop to EUR carry trades. USD rates look to be minded to ignore inflation worries, and hawkish soundbites. The next test is this week's FOMC minutes.

Source: Shutterstock

A glass half empty is good for carry

The outlook for risk sentiment remains clouded by the rise in Covid-19 cases in many places in the world. Interestingly, these worries are more clearly observed in rates than in other markets. This is not unusual in times when central banks retain a heavy hand in the pricing of financial assets. The logic goes like this:a further worsening of the outlook would prompt an even slower unwind of monetary support measures. This will logically support government bonds, the primary target of central bank purchases, but, indirectly, this will also support risk assets, hence the expression 'central bank put'.

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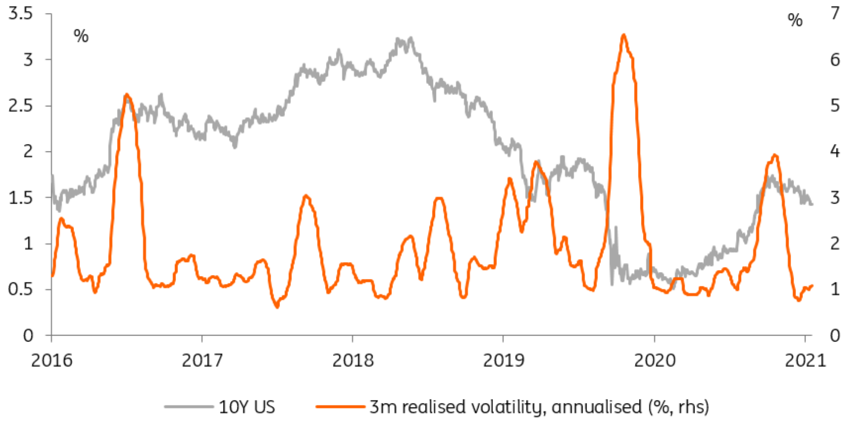
It helps that these worries are pushing investors in a direction they were inclined to go anyway, namely into carry trades. The exceptional amount of liquidity sloshing around, rising at a $120bn/m and €100bn/m clip thanks to the Fed and ECB respectively, means fixed income assets benefit from a strong tailwind. The risk of an even slower unwind of those measures plays no small part in capping USD and EUR rates.

Central banks helped suppress volatility, and growing Covid-19 risk is pushing investors into carry trades



Source: Refinitiv, ING

We doubt any rise in Spanish and Italian PMIs today will change this state of play. Firstly because it is already expected, judging from Bloomberg consensus. More importantly, markets are forward-looking and, if they expect another disastrous tourism season for Southern European countries, then the regain of optimism in June would go largely ignored. The ZEW survey tomorrow offers a better chance to get a timely read on market sentiment but, we doubt it will tell us something we don't already know.

USD rates ready to shrug more inflation worries

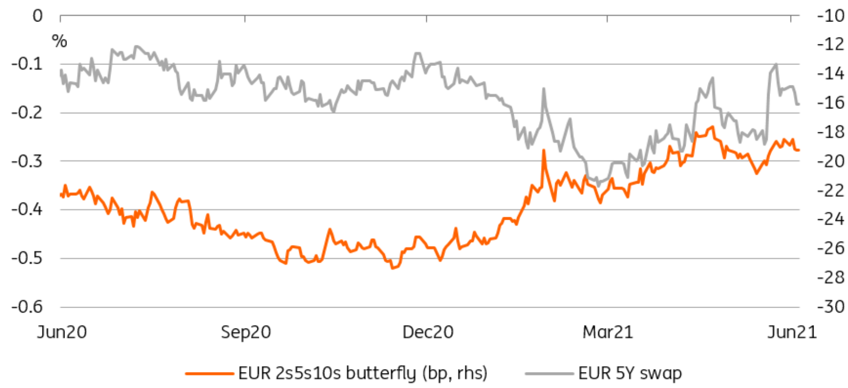
The lack of reaction to the US payroll beat on Friday is telling. It suggests that the focus has firmly shifted away from the risk of Fed tightening. The market doesn't buy it. Still, persistent macro noise still points at an overheating economy. The ISM services tomorrrow might add to those worries if it shows inflationary pressure building up, like its manufacturing equivalent.

Wednesday's FOMC minutes, relating to the June meeting, could add a layer of hawkish communication, as we suspect Powell is more likely to have given a dovish spin to the discussions that took place at that meeting but, here too, the market might decide not to care.

ECB: still finding reasons to be dovish

The ECB won't be completely off the radar as the governing council will meet later this week for a conclave aimed at ironing out the remaining differences on their strategy review. Headlines will abound, no doubt, but there a nagging suspicion that they will try to make something out of nothing. The less hawkish tilt implied in a different wording of the ECB's inflation goal is already well accepted by financial markets.

Already modest ECB hike expectations were pared back last week



Source: Refinitiv, ING

If there is a dovish risk, we think it rather stems from further concerns being voiced about the risk progrss of the delta variant. Lagarde said this much on Friday, but more comments along those lines could push rates market towards a shallower hiking path in the coming years.

Today's events and market view

The July 4th US holiday implies lower liquidity in financial markets. All else being equal, this mean that any ECB QE purchases can be potentially more impactful. We continue to see a skew towards lower EUR rates in the coming days.

Of the PMI services to be released today, Spain and Italy are first readings. Market are primed for an improvement already, so we suspect they will fail to lift the market's spirits.

ECB vice president Luis De Guidos is due to speak. We expect that the ECB is satisfied with its dovish message but further warnings about the delta variant would confirm investors in their appetite for carry trades.

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