

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

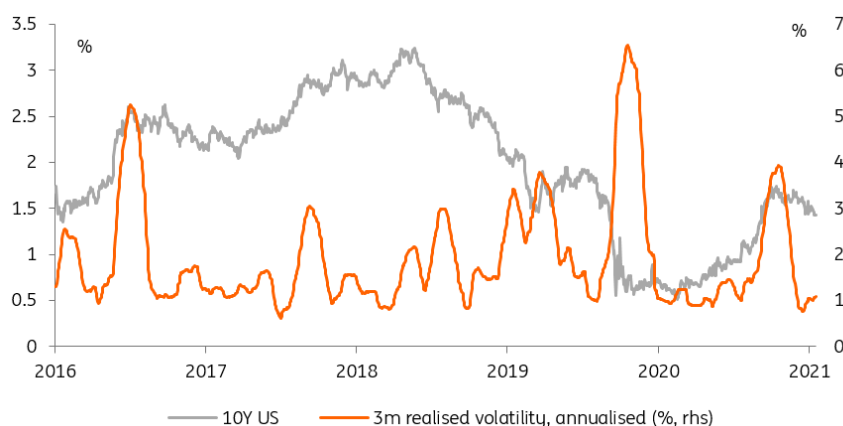
A glass half empty is good for carry

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'.

A further worsening of the outlook would prompt an even slower unwind of monetary support measures

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

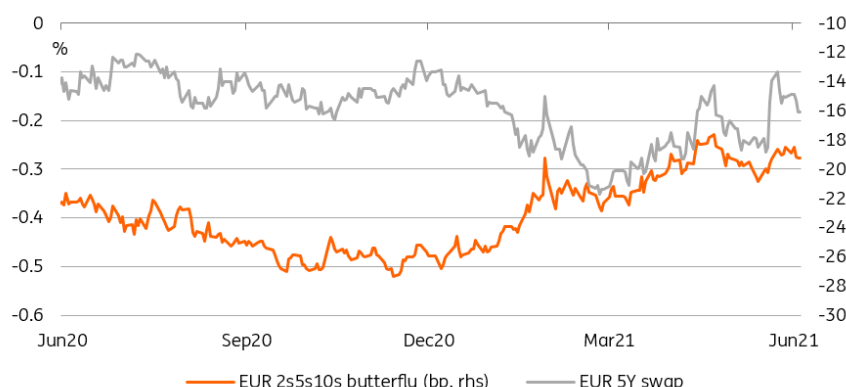
The lack of reaction to the US payroll beat on Friday is telling. It suggests that the focus has firmly shifted away from the risk of Fed tightening. The market doesn't buy it. Still, persistent macro noise still points at an overheating economy. The ISM services tomorrow might add to those worries if 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 progress 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 means 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. Markets are primed for an improvement already, so we suspect they will fail to lift the market's spirits.

ECB vice president Luis De Guindos 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.

Authors

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.