Rates Spark: Pivot and stretch

The front end of the US curve is approaching zero, as SOFR touched just 1bp yesterday - time for the Fed to technically adjust soon to ensure the effective funds rate don't follow; if only to show that all is under control. In the Eurozone, the ECB will look with some concern on widening sovereign spreads, just as Italy decides to go green.

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The front end of the US curve is approaching zero. Time for the Fed to think about acting

SOFR has hit a new low at just 1bp - so close to zero! (and potentially negative territory). The effective fed funds rate is holding at 7bp, but could easily begin to dip to 6bp. The all-time low was 4bp, but we feel that hitting 5bp would be enough to tempt an upward adjustment in the rate on excess reserves, to tempt some liquidity into that bucket, preventing the funds rate from getting too close to the floor at zero.

As we have noted in our sparks and money market updates, we have a combination of excess liquidity in play, but also a growing shortage of collateral. The Treasury will spend chunks of the US$1.7tr sitting on the Fed's balance sheet, morphing that into bank reserves and adding to the liquidity excess. At the same time the Treasury wants to reduce T-bill issuance, in proportional terms from over 25% of debt down towards 20% (it was 15%). Although they will increase longer tenor supply, that tends to be less active in repo.

> *As every repo player knows, excess liquidity will push down market rates, but add in less available collateral and you have a combination that would typically mark negative, just as an individual bond can go on special.*

The Fed has had little to say on this approach of SOFR to zero, apart from some useful reference in the minutes to a possible adjustment to the rate on excess reserves or repo if required to manage the effect funds rate. But this is in any case all very important, as system stability starts on the money/repo markets.

And by the way, some of this excess liquidity will make its way into risk assets, so it is in the Fed's interest to do some mopping up. The less talk about negative rates the better from their perspective, and especially if they are seen to be propping up stocks too (they are not, but that's how the conversation could go).

Still higher as the Fed steps aside the ECB has no more than words

The trend higher remains intact, lifting 10Y UST yields above 1.40% yesterday. If there were any hopes that Fed Chair Jay Powell might reconsider his stance with regards to rising yields on his second day of testimony to Congress, they were disappointed again. He continues to see in them a vote of confidence in an improving outlook rather than anything too concerning. And other Fed officials such as Lael Brainard yesterday stressed again the near-term increase in inflation is more related to temporary supply constraints as the economy reopens. In all, the Fed's view remains that it is still far away from reaching its goals on both inflation and employment.

> *The negative feedback loop of higher rates into risk assets has started to surface more often*

However, the negative feedback loop of higher rates into risk assets has started to surface more often. In the eurozone that means we are also seeing periphery countries' bond spreads over German Bunds under widening pressure – another element of the ECB's assessment of funding conditions that is turning less favourable despite Christine Lagarde's verbal efforts earlier this week.

Lights still on green for Italy?

The spread of 10Y Italy is testing the 100bp mark again these days, a level not seen since early February. Whether this is higher volatility taking its toll on carry trades remains to be seen. For now we are tempted to blame the underperformance of Italy, at least partially, on the prospect of an inaugural Italian green bond being in the pipeline. Today the debt agency will present its green bond framework after signalling the launch of a first green issue within the first quarter in its 2021 outlook last year.

€24bn of green bonds

issued by Eurozone sovereigns in 2020

Italy's entrance to the growing eurozone green sovereign bond market would follow France, Belgium, Ireland, the Netherlands, and last year's new entrant Germany. €24bn had been issued by these countries in 2020. A new green BTP would give a boost to this segment which has seen issuance of just below €4bn year to date. Eventually we will also see Germany expanding its green curve with a new 30Y and 10Y bond. France also still plans a new green 20Y bond and next to Italy another possible new eurozone sovereign entering the market could be Spain.

Today's events and market view

There wasn't much of a catalyst behind yesterday's move. With the US stimulus bill making its way through Congress and a house vote expected for tomorrow we fail to see anything that could derail the trend unless we get a greater hiccup in risk assets or more forceful intervention from the official side. Here we are not holding our breath for anything out of the US at least. On the data front we have durable goods order, initial jobless claims and the second estimate for 4Q GDP. That could be revised higher, but only marginally at best, according to our economist. A technical factor that could provide support to bonds are the month end index extensions.

We fail to see anything that could derail the trend

In EUR rates the prospect of a longer-dated EU deal could keep yields from seeing larger relief. The EU sent out an RFP for a SURE-related social bond deal. The past couple of times such an announcement came on a Friday with a deal following two weeks later. The pattern this time might indicate a deal as soon as next week. According to the latest investor presentation, the EU aims to raise another €20bn this quarter. A dual tranche deal could raise more than half of the targeted amount.

In primary markets today, Italy will launch a new 5Y bond for up to €5bn and reopen a floating rate CCTeu for up to €1.25bn.

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