Rates Spark: Something is lurking out there

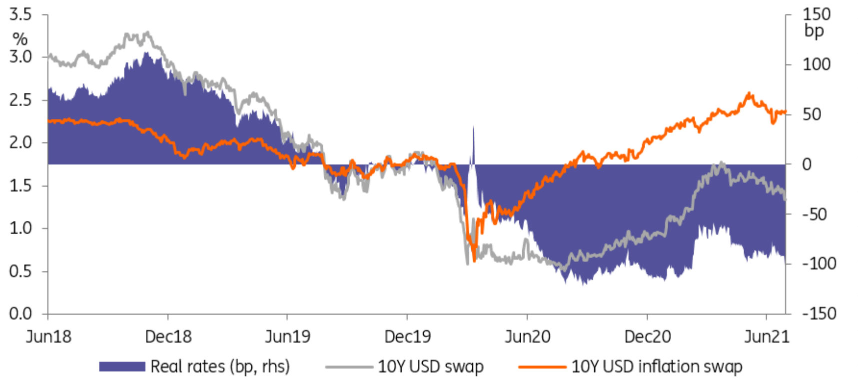
The fall in market rates has little to do with the Fed, at least not directly. Rates were falling long before the Fed had its hawkish wake-up moment. Real rates have remained stubbornly negative too - made little sense against a vibrant macro story. The bond market sees that of course, but for some time it has had doubts about the longer term, rightly or wrongly.

Source: Shutterstock

Falls in long rates should not be a surprise, as this has been building. But it also complicates matters ...

Something had to give. Literally for months now long end rates have been more minded to test lower than higher. The US 10yr hit 1.75% in March, and since then there have been some ups and some downs but mostly the latter. That same 10yr rate is now closer to 1% than it is to 2% - a remarkable state of affairs given the strength of the recovery, and more to come. At the same time, the bond market has been in a state of extremes. On the one hand it was pricing in more inflation, but on the other it did this partly through deep negative real market rates, which in turn co-existed with maintenance of low nominal rates (relative to inflation). We've been through big inflation prints, and big growth ones, but this bond market has not been fazed. By the same token those that link the fall in long rates to some calming in survey evidence are also missing the point. This bond market has never been completely convinced that the medium term outlook is green for go.

With the latest rally , 10Y real rates have plunged back to -100bp



Source: Refinitiv, ING

This bond market has never been completely convinced that the medium term outlook is green for go

So what now? Testing lower in yield until testing higher makes no sense. The bond market likely needs to get this out of its system. But by the same token be careful here. Carry trades are a slow-burn positive mark to market plays. But this is no longer a carry trade; it's a performance trade. And as that trade gets busier, volatility increases, and that's where this thing can turn quite quickly. But a turn likely needs a catalyst, and there is not an obvious one ahead. Concrete taper talk could be one. The Fed minutes should be watched here. But at the same time the Fed itself will be a tad perturbed by all of this. It in fact complicates matters. The Fed was in the luxury position of facilitating boom-like conditions and holding back on hawkish rhetoric. A policy tightening then would look perfectly in turn. But if long rates were to continue to fall, before the Fed had hiked by much ahead, they would be at risk of inverting the curve.

The fall in market rates has come from falls in real yields; now -100bp in the 10yr

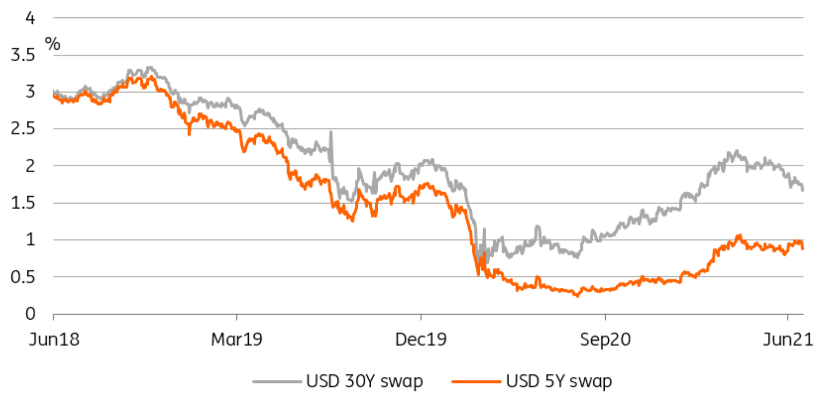
A disturbing additional element here is that the fall in market rates has come from falls in real yields. The 10yr real yield is now back in the -100bp area. It's not the first time we've drawn attention to this; and it just won't go away. It is tough to be medium-term positive with this as a central discount for the future. This may prove to be just a phase, but it certainly has the attention of doubters. Fixed rate payers will now be looking for new ultra-low levels from which to reset from.

Combing a wall of (supply constraint) worries

The narrative according to which the US recovery is running out of road due to excess demand/insufficient supply capacity is the one that best explains the aggressive flattening of yield curves globally. It makes sense, but we find the economic expectations baked in the yield curve too pessimistic, and slightly contradictory. If medium term prospects are so dismal, then concerns about too aggressive a Fed tightening seem exaggerated in our view, unless one doubts its ability to look through the current spike in inflation.

Still, further curve flattening was, and remains, the right call, we just expected it to be more led by higher front-end than by lower long-end rates. This is also the call most consistent with growing risk aversion in financial markets. The slow drip of higher Covid-19 cases is indeed cause for concern but continuing reopening plans in the UK and a lower propensity to impose lockdowns in the US mean the economic implications are not straightforward.

30Y rates aren't supported by potential Fed hikes, unlike 5Y



Source: Refinitiv, ING

Wait a minute

The FOMC minutes today might also accelerate the curve flattening impetus, depending on how high do near term inflation worries rank in the list of factors that drove members to bring forward their hike expectations. We think their hawkish shift was all about inflation risk so, if anything, reports like the June ISMs showing supply constraints and price pressure will compound the message contained in the minutes. In the current market mindset, this will reinforce early hikes being priced in the curve, and also a lower terminal rates, although we are sceptical about this last part.

Today's events and market view

The June FOMC minutes will provide much of the action but the release is relatively late in the day for European markets. Ahead of the minutes, US job openings will be the main release of note. Our US economist has highlighted the rate at which employees leave their job as a key indicator of how hot the job market has become. This is the sort of data point that prevents short-end rates from ignoring inflation worries, and leaves the curve flatter.

The morning will be comparatively more quiet but look out for the European Commission updating its economic forecasts.

Authors

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Disclaimer