Rates Spark: Not listening

The rise in US yields has been a driver of higher core yields globally, and with US real yields still in the negative, there is room for upside. We note a cheapening in the 5yr area too, which is typical when bonds sell-off. The Fed is sitting put, preferring to offer guarantees on front end stability. The back end can go and find its own level, for now at least.

Source: Shutterstock

US 10-year at 1.5% - a world away from where it was, and its not done yet

The US 10-year got a bit carried away yesterday, in fact briefly touching 1.6%, but eventually settled at 1.5%.

It's been quite the move from the already lofty level of 1.3% seen only a week ago coinciding with changes to the structure of the curve too, as the 5-year area has begun a cheapening that is reminiscent of what we saw during the 2013 taper tantrum.

This is turning into an inflation tantrum. In the end, a spot of tapering later in 2021 may be needed to offer some inflation protection to the back end, which at the moment feels quite vulnerable.

Official policy is exceptionally easy, and Fed Chair Jerome Powell decided not to take the opportunity to calm things this week, which is understandable.

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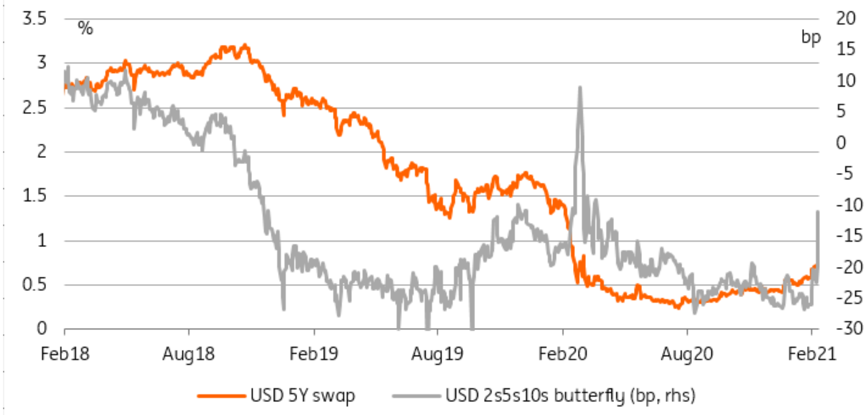
The reality is the economy is beginning to motor. We may still be in the midst of a pandemic, but there is also a sense of better things to come as we progress through 2021, including a nailed on 3 handle to US inflation (and likely higher, for a spell). It may be "base effect" driven, but it could also linger at elevated levels for longer than many anticipate.

And real rates, while higher now, are still deeply negative. The -90bp real rate in the 10-year provides a measure as to how much yields could rise before they start to look toppy, on the assumption that a zero real yield should be a sensible near-to-medium target.

And keep an eye on SOFR. It edged higher yesterday, but to just 2 basis point (up from 1bp). Even though equity markets tanked late yesterday, part of the froth in the system is coming from the buckets of liquidity that is swooshing around. It's just a small part, but one that the Fed will want to tighten up. There is a rate hike coming. Not a fed funds hike, but a hike in repo and excess reserve rates, as popping negative on the ultra front end would just look all wrong here.

5Y, the policy-sensitive part of the curve, has borne the brunt of the sell-off



Source: Refinitiv, ING

The ECB talks but where's the walk: the stakes are high

Away from the US, EUR and GBP rates have been more than happy to follow in lockstep the move of their USD counterparts.

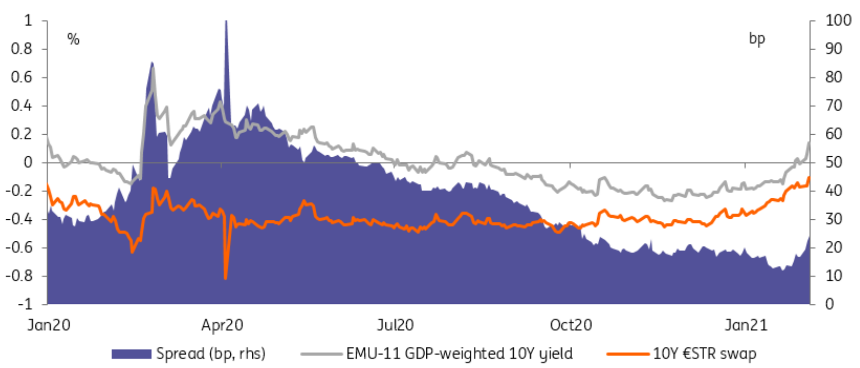
In both cases, we think the market moves are disconnected from economic realities. The Eurozone for example is an economic laggard and its vaccination programme is taking time to get off the ground. There have been better news from the UK of late, but the medium-term economic and inflation picture does not warrant such a jump in yields.

The situation in the Eurozone stands out for more than just its low vaccination drive. The ECB, unlike the Fed, has been actively trying to manage interest rates, or at least to slow the pace of rise. There are a number of reasons for its failure so far but the main one is that it has yet to actually step up its bond purchases to calm the market. ECB Chief Economist Philip Lane raised the prospect in a speech yesterday and laid the theoretical justification for greater intervention adding that the ECB is not engaging in yield curve control.

We suspect ECB intervention is imminent

We suspect intervention is imminent, or perhaps we are letting our hopes speak. One doesn't have to look far to see the implication of the ECB talking the talk without walking the walk. Italian spreads have been on a widening path since the middle of the month. Even if Italian yields are still close to record lows, they are typically the canary in the bond market's coal mine. Higher rates volatility is detrimental to carry trades. The recent Italian spread widening could be an early sign of investors reconsidering owning debt at wafer-thin spread levels that offers little protection against inflation, higher rates, or an economic downturn.

Sovereign bond yields, especially Italy's, are most at risk in a rates sell-off



Source: Refinitiv, ING

Today's events and market views

February inflation numbers in France and Spain could complicate the ECB's communication. It has flagged that it would look through any temporary spike in inflation but markets are myopically focused on signs that could herald higher rates.

In the US, personal income and spending will be followed by the University of Michigan sentiment.

ECB intervention to be more imminent than the Fed's

As we explained above, we expect ECB intervention to be more imminent than the Fed's, but both have reasons to be concerned. On balance, this should help widen the USD-EUR spread differential further. As we have made clear in recent days, momentum alone justifies our expectation for higher interest rates in the near-term, and we are inclined to stick to this view.

Counter-arguments include month-end balancing flow away from stocks and into bonds, maturity extension flow, and twitchiness in the stock markets. They are all valid points but we suspect more bond selling and swap receiving has to emerge from market participants not appropriately geared for this level of volatility.

Author

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

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

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com