Rates Spark: On your own

No pushback against higher yields from the Fed and the BoE leaves the door open for further rises. In the near term an extension of the SLR might provide temporary respite. That does not relieve the ECB of its struggle to keep a lid on rates. The large TLTRO is scant consolation.

The long end is on its own

The sell-off in US rates extended after Fed Chair Powell left the long end of the yield curve unprotected. The 10Y UST yield reached 1.75%, and the 1.75-2% range appears to be where the market wants to eventually get to. 30Y yields briefly topped 2.5%. Coincidentally that is the median level of the Fed's longer run projections in the dot plot. If that were to serve as a soft cap it could imply that the dynamics are tilting more towards 10s30s flattening as yields rise further. And we think even higher yields is still where we are headed, eying 2% later this year in the 10Y.

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Near term there is still one issue that needs adressing: the exemption of banks' reserves held at the Fed and US Treasury holdings from their capital requirements (SLR) runs out at the end of this month. A decision could come as soon as Monday. We still think an extension of the exemption is more likely than not, but it is also not straightforward. At the recent meeting the Fed substantially increased the counterparty of its reverse repo programmme (RRP). One could argue it is another release valve for the pressure stemming from a high level of reserves in the financial system, and one that has an even wider reach than a hike in the interest on excess reserves (IOER). But could it also be enough to offset a potential end to the exemption of excess reserves? This question may keep Treasury markets on their toes in coming sessions.

Should relief be granted then also the supply outlook for coming weeks may allow for at least a temporary topping out of US rates. The next longer-dated UST auctions are only in the second week of April, leaving next week a (still potentially itchy, as we have already experienced) 7Y auction alongside a 2Y and 5Y.

How much can the ECB do?

EUR rates have been dragged higher alongside US rates. The 10Y Bund yield ended yesterday close to -0.26%, the highest since late February and up from below -0.30% going into last week's ECB meeting. This was when the ECB announced the increase in asset purchases to stem the rise in market interest rates. Next Monday, we will get a first indication of the volumes involveld when the data for weekly net asset purchases is released. To be fair, while Bund yields have increased, the spread versus the 10Y UST has widened to 200bp. In all likelyhood that would not have been the case without the ECB.

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On the positive side, the ECB allotted more than €330bn in yesterday's targeted liquidity operation. It was higher than most market participants (including us) had expected and is indeed the second largest TLTRO.III tranche, only surpassed by the €1.3tn allotment of June last year. Nonetheless the direct market impact has been marginal, with only very subtle tightening in forward money market spreads and shorter dated government bond spreads on the back of the news itself. The general positive impact on sentiment may help support spreads, but eventually the larger impact further down the line could be in other sectors, for instance on the bond issuance activities of banks as market funding needs are reduced.

To distract somewhat from the rise in market rates, the ECB could argue that the TLTRO is also contributing towards maintaining favourable financing conditions. If all efforts including the PEPP are seen as a package, then maybe higher bond yield levels can be tolerated? Still the optics of 10Y Bund yields surpassing -0.26% just after announcing to step up purchases are bad.

Today's events and market view

No pushback against higher yields from the Fed and the BoE (more on the latter here) leaves the door open for further rises. Of course that hinges on whether risk assets continue to hold up.

The ECB as the one central bank to have pledged to actively counter the rise in bond yields, is left in a pickle. All the more attention will fall on the remark's of officials especially as the data calendar today has little else to offer. Among others ECB's Panetta will speak. He had suggested that last December's market conditions could serve as benchmark for 'favourable financing conditions' - obviously we have moved further away from that target.

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