# Rates Strategy: Glass half full - Really?

Data today should allow markets to see the glass half-full. We have reservations but don't exclude a temporary jump in rates today. Some central bankers are showing signs of optimism. We hope they are right. The Fed funds strip has different ideas, as it has reverted back into negative territory. And 2-4yr USD IRS swap rates are below 3mth Libor - no "V" there.

## Cautious optimism but is it warranted?

For today's session, it is possible that better economic data drowns out the noise from rising covid cases globally. Survey indices (European PMIs, US ISM) in particular have a tendency to revert to the mean after their sharp drop in recent months but only due to a stabilisation of activity at low levels. The risk of another spike in EUR or USD interest rates on these data today is not negligible but we do not expect it to be sustained.

As we noted yesterday, there is a trend, amid general caution, towards central bankers striking a more upbeat tone of late. It is no doubt a reflection of the stabilisation in some economic indicators mentioned above. We do not infer from this that the bar to further easing has risen, especially not in the Eurozone, but this display of optimism comes at a time the risk of further damage from the epidemic is growing. Granted, reaction to a second wave would perhaps entail more localised lockdown measures than in the first, but we would expect a more forceful response in EU states than in the US states currently in the news.

Haldane of the BOE was the latest central banker to voice his hope of a V-shaped recovery, based in part on high frequency indicators. As the sole dissenter to last month's decision to boost QE, his optimism is perhaps not surprising. Among the reasons invoked for stopping QE was the sharp improvement in market conditions. We agree that the dynamics prevalent at some point in March of Gilts selling off on risk-off days was particularly worrying, and that money market conditions have improved. The ability of interest rates markets to withstand another shock depends largely on the assumption that central banks would step in quickly however.

## Against a backdrop where the US fed funds strip marks negative

The fed funds strip is not exactly pricing in a V-shape recovery.

From September 2021 onwards it dips into negative territory for a full year (to Sep 2022). It is only negative to the tune of a basis point of two, but this is still a remarkable discount. It is not a new one. It has basically been there on and off since since early May; see our note on that here. There have been weeks where the negative discount has unwound, for example when the 10yr broke briefly above 90bp. But we have been back in negative territory again in the past week or so.

This gives us an insight into the rates market mindset. It discounts low rates for an extended period, not because interest rate caps are under discussion, but because that is the baseline expectation. This can also be gleaned from the USD IRS curve. The Libor 3mth rate is 30bp, but the 2yr, 3yr and 4yr IRS rates are below that, ranging from 22bp to 27bp. The 5yr at 32bp is only marginally above 3mth Libor.

We believe that these present great opportunities for lock-ins at a pickup to Libor - certainty for free. But this profile is also one that discounts no material change in rates for at least the coming 4-5 years. There is nothing "V" about that profile.

## Today's events: New 15Y Portugal bond, key US data, FOMC minutes and EZ final manufacturing PMIs

Portugal will take centre stage in the eurozone primary markets with the syndicated sale of a new 15Y bond. Only last month the debt agency had provided a revised funding plan indicating that it wants to raise €29.3bn via bonds this year, compared to the original guidance of €16.7bn. It also flagged that it planned to raise the funding via syndications and auctions in 3Q, so yesterday's announcement of today's deal was not entirely surprising. The long end sector of the Portuguese bond curve had already underperformed versus peers over the course of the past week. That said, Portugal has already executed €17.2bn, or 59%, of this year's new target.

In data the focus is on the US ADP private payrolls data ahead of the official US jobs report tomorrow (one day earlier given the holiday ahead of 4th July) as well as ISM manufacturing. The latter index could jump to 50, but that would not suggest growth, as the level of activity is down hugely versus the start of the year. In the evening the Fed will release the minutes of the 10 June meeting, which could shed more light on how far discussions on forward guidance and yield curve control have come. The eurozone sees the releases of the final manufacturing PMIs.

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