Rates Spark: US Treasuries brave the first supply test

First country inflation and growth indications ahead of today's aggregate eurozone data have already confirmed the ECB's more dovish tone of the last meeting. Meanwhile, markets' worst fears have not materialised in the Treasury's quarterly borrowing announcement, although concerns about the overall US debt trajectory remain unaddressed

Bund curve steepens on dovish data and improving risk sentiment

The first eurozone inflation readings confirmed the European Central Bank’s somewhat more dovish tone and decision to hold rates at the recent meeting. German inflation dropped to 3% year-on-year, noticeably cooler than the 3.3% the market was looking for. Similarly, Spanish inflation also came in cooler.

ECB officials have tried to limit the downside in rates. The ECB’s Kasimir and Simkus both dismissed any notion of the ECB cutting rates already in the first half of next year. They were not the first ones to spell out how 'high for longer' should be interpreted. Two weeks ago Klaas Knot had pointed to holding key rates for at least a year. However, even though the early rally in rates started to fade they could not entirely prevent a slight bull steepening of the curve.

The second feature of the European session was a backdrop of improving risk sentiment that also exerted upward pressure on rates to fade the initial rally. That change of tone was especially felt by Italian sovereign bond spreads with the key 10Y spread over German Bunds tightening towards 190bp, its tightest since early October. However, it was the ECB not having discussed the possible slowing of pandemic emergency purchase programme reinvestments – although that debate has only been postponed – as well as rating affirmations last week by DBRS and earlier by S&P that have laid the basis for this tightening.

US borrowing for Q4 lower than expected, but Q1 somewhat higher

US rates moving higher in anticipation of the Treasury's borrowing estimates were a third factor that also pulled EUR rates up from the day's lows. In the end the Treasury lowered the fourth quarter borrowing estimate to US$776bn from the guidance of US$852bn which it had provided in August. This also helped dampen the impact of the initial borrowing guidance for the first quarter of next year coming in at US$816bn, which was toward the higher end of market expectations.

The market's worst fears have not materialised and the yield increase on the day was thus modest with 10Y UST yields staying below 4.9% in the wake of the announcement. The relief in very long-end rates resulted in a 2bp flattening of the 10s30s curve while 2s10s ended little changed. The market is still waiting for the maturity split of the funding which will be announced on Wednesday. And while the quarterly funding may have come in a bit lower, concerns surrounding the longer term trajectory of the US deficit remain unaddressed.

Today's events and market view

A fourth overarching factor leading to wider upward pressure on rates were reports in the lead up to the Bank of Japan meeting that hinted of possible tweaks of the yield curve control framework to potentially allow the 10Y JGB yield to rise above 1%. in the end it was only a slight tweak, the upper 1% threshold was rephrased to be reference point, thus allowing more flexible approach to controlling the yield. The 10Y UST yield eased back towards 4.86% after the decision.

Main events over today's session are the CPI flash estimate and third quarter GDP data for the eurozone. The indications from yesterday's country data point to cooler inflation than consensus has forecasted while the growth figures should point to an economy mired in stagnation. This should come as affirmation of 10Y UST-Bund spread at its currently elevated levels of above 200bp.

While the next US main events are lined up for tomorrow with the quarterly refunding announcement and the FOMC meeting, today's quarterly employment cost index should not be dismissed. After all it is the Fed's preferred wage metric, and is expected to come in at 1% quarter-on-quarter. We will also get house price data and the Conference Board's consumer confidence index.

Today's government bond supply will come from Italy, which sells 4Y, 6Y and 10Y bonds as well as floating rate notes for up to €8.75bn in total.

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