

## US market rates bracing for 1%

Equity markets have swapped their spectacles for bond market ones and are finally seeing some angst down the line. That has helped bond yields push through an open door to even lower yields. We now eye 1% as a level that market rates could pepper in the next month or so. Bonds will continue to front-run the Fed, as ultimately a rate cut is no cure for the flu.



### The Coronavirus effect

Covid-19 is the type of catalyst that both risk assets and core bond markets had been watching for, but from very different perspectives.

1. Bond markets were already trading as if there was trouble ahead (flat curve, rich 5yr valuation and rate cut discount).
2. Equity markets and risk assets generally were motoring ahead, but eyeing the blind spot for a pull-back risk.

The early reaction to Covid-19 had been a tad perverse. The US 10yr fell from 1.8% to 1.6% for starters. But equity markets saw the glass as half full - lower bond yields meant a heightened chance for a rate cut. That, plus a still benign inflation backdrop classically presents a positive

underpinning for risk assets.

Fast forward, and there has clearly been a tipping point where vulnerability has been extrapolated. Risk assets have begun to look through bond market spectacles, and are now eyeing risks that are not immediately solvable through simple rate cuts. In turn we expect to see bond yields continue to significantly front run any Fed rate-cut response.

---

*"Interest rate cuts will neither cure anyone's flu, nor avert close-down risks for areas that have or will become Covid-19 impacted."*

---

The only logical rationale for an imminent interest rate cut is for the interests of financial market stability e.g. a case where the equity market sell-off turned into an uncontrollable rout. Beyond that, interest rate cuts will neither cure anyone's flu, nor avert close-down risks for areas that have or will become Covid-19 impacted.

Market rates, in consequence, have and will likely continue to lead any official response from the Federal Reserve. The Fed will be comforted in the fact that policy has already been eased by 75bp (in 2019), and as we turned the year into 2020 the Fed was in the process of balance sheet re-building / liquidity injecting. So no need to panic here, yet.

## Excess demand is a central driver

Before going into predictions for yields, there is one important (non-Covid-19) factor to consider – the excess of demand over supply for fixed income as a theme. Despite heavier USD bond supply, the demand for fixed income has been overwhelming; hence the persistent fall in yields.

---

*"Despite heavier USD bond supply, the demand for fixed income has been overwhelming; hence the persistent fall in yields"*

---

The demand side includes some key captive players. These include central banks (QE), private banks (regulatory liquidity buckets) and pension funds (ALM through “near-AAA” discount functions). On top of that players, like insurance companies, that have been forced out the credit curve for yield, have barbelled into core rates too.

And bigger picture impulses are in play too. European (negative) yields remain a drag for US ones, as do the likes of Japanese and Northern European ones generally. The persistent flow of funds into USD has been a coincident outcome from this, which has become a circular process, pushing yields down and USD product up.

These were all in play well before Covid-19 hit.

## Covid-19 and final thoughts

The Coronavirus backdrop has provided an open door for core bond markets to push through. The 5yr part of the curve has taken the lead, now at 1.15% as we head for the US close; a full 40bp through the effective Fed funds rate. The 30yr at sub-1.8% is just a smidgen above the Fed funds rate ceiling.

As nominal rates have fallen, there has also been a compression versus TIPS yields, resulting in a big falls in implied breakeven inflation - the 10yr B/E is now only a tad above 1.5%. This is a remarkably low market discount for US inflation over the next 10 years, in turn providing fuel for calls for the Fed to step in with some rate cuts.

---

*"Calling the Covid-19 spread is a mugs game. But the fear factor that comes from any / every material geographical breakout is now predictable"*

---

Calling the Covid-19 spread is a mugs game. But the fear factor that comes from any / every material geographical breakout is now predictable, which points to material slowdown, both direct and indirect. Against this backdrop, there is likely room for yields to test lower from here, even if ultimately morphing into an overshoot to the downside.

The 1% level is a natural target, and we can envisage a scenario where the curve begins to pepper that level in the coming weeks and months, at least along the 2yr to 10yr segment. The 5yr would likely make the break below first, as the 2/5yr segment continues to invert. And the 10yr would not be too far behind as the overall curve maintains a flattening tendency (until the point where the Fed feels the need to cut).

### 1 And now for the technical bit

The US 10yr yield, now at an all-time low, does not trade through the Fed funds rate very often. When it has, it has typically been followed by significant Fed funds rate cuts.

## The 10yr breaks below the cycle low and well through fed funds

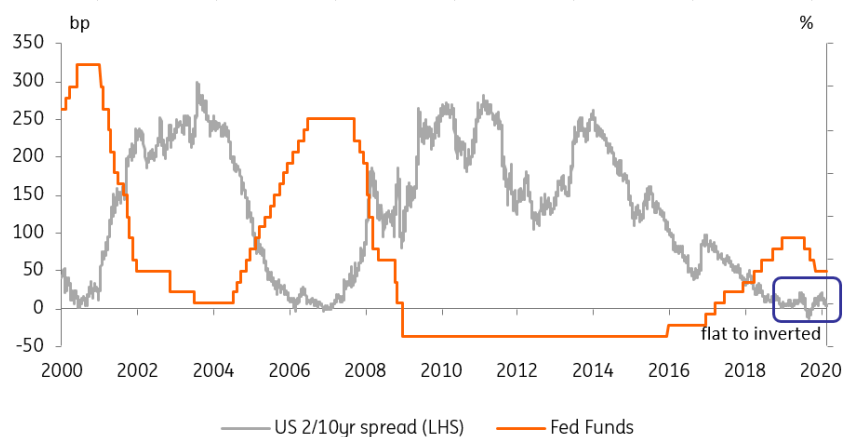


Source: Bloomberg

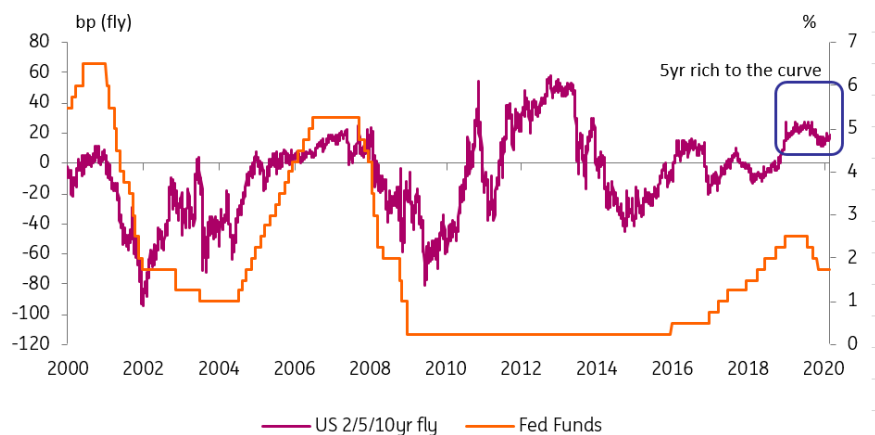
The US 2yr has been some 100bp lower than current levels, back when the funds rate was at zero-25bp. At 1.2% it is discounting at least two 25bp cuts.



History also shows that extreme curve flatness (and/or inversion) typically precedes a rate cutting process.



The inversion on the 2/5yr segment has coincided with the 5yr trading rich to the curve. A rich 5yr flags a tendency for lower rates.



Note the maintenance of richness on the 5yr segment even after the Fed had delivered 3\*25bp in rate cuts in 2019. This is unusual. Once the Fed has started a rate cutting cycle, the 5yr would typically revert to a cheaper valuation. Instead sustained 5yr richness pointed to an unfinished lower rates process, and that was before Covid-19 hit.

## Author

**Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit [www.ing.com](http://www.ing.com).