

## Break on through...or don't

A quiet day for Asian markets beckons ahead of the US-non-farm payrolls report, but could the quiet be about to end? I hope so, but I wouldn't bet on it



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### Range trade continues

I wrote at the beginning of this week - when my G-7 colleagues were on holiday and markets were quiet - that this week could see the tight ranges that markets have recently inhabited broken - though it was more of a hope than a prediction.

That range behaviour seems even more entrenched now. Take EURUSD for example. While it has been basically static at about 1.22 all week, it has on alternate days had a foray lower, then higher, then lower again in the most recent session. On all occasions, after straying a little from the prevailing trend, the opponents of the move have come in and swiftly brought it back in line.

Much the same is happening with 10Y US Treasuries. Asian FX has been more volatile, but has also shown little appetite for directional trends, especially after the PBOC's recent CNY cooling measures. Stocks too are essentially flat.

What's going to break this? There are numerous contenders...

## "Nerfing" the taper

One possible source of the range-trade breakout might be the Fed themselves. Having dampened markets' expectations for rate hikes and a taper with a seemingly coordinated chorus of "don't worry, inflation is only temporary" (T-shirts, coffee mugs and other merchandise will no doubt follow...) the only new direction the Fed can really take is to become slightly more hawkish. But they can also "nerf" any impact this will have by focussing any initial tapering on the MBS and not the Treasury market. So this may not deliver the jolt that many have been suggesting. Overnight comments from the Fed's Clarida and Harker suggest the Fed's response, for now, is to at least start talking about a taper, though without committing to anything for the time being. This is allaying some fears that the Fed is falling behind the curve, though it is a delicate balancing act between keeping anti-inflation credentials intact and avoiding spooking the front end of the bond market. So far, The Fed members are managing to do this pretty well. But accidents can happen, and given time, they become practically unavoidable. For more on this and some further commentary on market liquidity, [see the linked note from our Rates Strategy team](#).

I read a news article today that suggested that inflation expectations are not where to look towards for any further break in Treasuries. I'm not sure about this. Inflation expectations the world round are an adaptive response to actual inflation. US Inflation hasn't peaked yet. And even when it does next month, any decline may be pretty moderate. I'd say there is definitely 10-20bp of 10Y yield increase possible from breakeven rates, maybe more. Last night's Beige Book certainly seems to suggest that inflation pressures remain a factor, and a real surprise would be if inflation managed to make a further small gain following next month's release, although the hurdle for doing so is high, with at least a 0.5-0.6%MoM increase needed for the June release (that's less than the recent 3m run rate however!).

As far as real rates go, Friday's payrolls may help to give them a small lift, though we concede that progress on any further fiscal spending in the US is probably going to be needed to give real rates a more significant push - and that is not likely to be forthcoming any time soon. Moreover, payrolls can disappoint just as easily as they may unwind last month's weakness. So directionally, payrolls aren't much help until we see the actual numbers.

## Aside from Fed and US stuff, China Covid is the thing to watch

But besides all the Fed and inflation-watching stuff that fascinates markets, closer to home, we are keeping a wary eye on the daily Covid-19 case numbers from China. 24 cases today and 23 yesterday. That isn't much. But the authorities there have already acted strongly in restricting travel in Guangzhou and temporarily shutting ports in Yantian, Shenzhen, where an outbreak of the Delta virus was first noted.

In Asia, it doesn't take much for the virus to have a big economic impact, as the authorities' reaction functions across the region are much more aggressive than they are in the US or in Europe.

Consequently, if a China outbreak becomes more widespread, then this has big ramifications for all markets, from commodities to currencies and bonds. This needs close watching.

## Author

### Robert Carnell

Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

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