

Oomph outweighs angst, pushing market rates up

Market rates are feeling the pressure. Risk assets have been bought into, and inflation is not calming fast enough. Central banks are piling further pressure on them. The US 10yr Treasury yield won't look right until it hits 4% and can take out the prior high. The 10yr Bund yield should get back to 2.75%, at least, and can still look up, possibly to about 3%



The bond bear market bubble has burst

The journey for 10yr rates is back to March highs

Market rates peaked in March this year. At the time, there was what looked like a relentless rise in rates underway, only to be undercut by the sudden and unexpected implosion of Silicon Valley Bank (SVB), with echoes in Europe as Credit Suisse was forced into a merger. There have been ripples of concern since, but apart from another few manageable banking casualties in the US, there has been a calming of nerves. In fact, we managed to morph from a state of material concern for the system to one of outright 'risk-on'. The coincident rise in market rates is an outcome of this. Plus there's sticky inflation in both Europe and the US (and beyond), and in the US an economy that just won't lie down. So where now?

On the one hand, forward-looking indicators are in a recessionary state, small bank vulnerabilities remain, and lending standards are tight. The eurozone has moved into a state of technical recession, and China is showing only a subdued reopening oomph. That, together with the cumulative effects of rate hikes already delivered, plus the negative real wage growth environment, should ultimately place material downward pressure on market rates as we progress through the second half of 2023. A peaking out for official rate hikes from both the Federal Reserve and the European Central Bank in the coming months would mark an important point in the cycle. From that point on, market rates should be on the decline, and yield curves should be in a dis-inversion mode.

But we are not at that point just yet. The latest US core PCE number at 4.9% reminds us that the US is still a "5% inflation economy". We think this will change (inflation will ease lower), but for now, it is what it is until dis-proven. In the eurozone, there has been a material easing in inflation rates, but the headline reading is still high, at 5.5%. UK inflation seems to have stopped falling, but it is still close to 9%, requiring the Bank of England to re-accelerate hikes. In the US, the latest consumer confidence number for June popped back out to 109.7 (versus 100 at neutral). All of this places upward pressure on market rates, and these factors are likely to sustain the upward pressure, at least for as long as an underlying oomph factor remains in play.

There is more room to the downside for market rates, but we will go up first

Given all of this, we anticipate that the US 10yr Treasury yield can get back above 4%, back to where it was before the SVB story changed the dynamic. The 10yr could well take out the previous high, and remain elevated for a time. With European central banks tending to show urgency on the inflation issue, there is ample room for eurozone market rates to rise too. The 10yr Bund yield is quite likely to break back above 2.5%, and then trend towards 3%. The cycle high seen when SVB went down was 2.75% – that's liable to be taken out.

We think these are moves that should be faded through, as increasingly we expect the residual oomph factor to be outweighed by an increasing angst factor. Growing unease with respect to the commercial real estate loan portfolios being held by banks will also begin to count. And further falls in inflation should be a natural outcome as demand slows. Once key core inflation readings have moved below 3%, the way will be clear for the Fed to consider rate cuts. A 2% handle is all that's needed (so, for example, 2.9% will be good enough). The ECB won't be too far behind. So sure, anticipate further rises in market rates now, but prepare for much bigger falls ahead.

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