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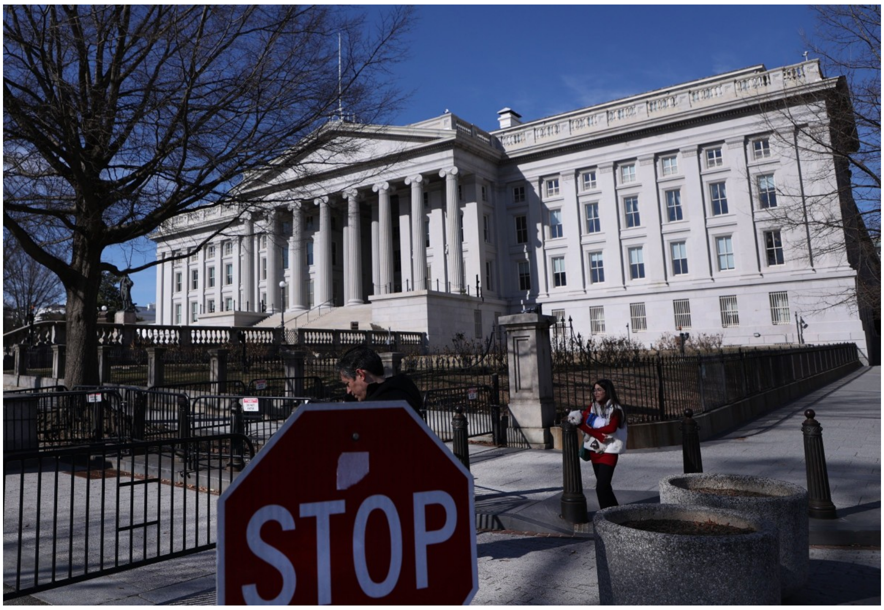
Rates: a Jekyll and Hyde bond market

It's difficult to forget the recent selling pressure on US Treasuries, which has left lingering risks. Since then, there has been a shift back to a more traditional fear of macro weakness. This could initially lower yields and drag European yields down with them. But correlation could turn negative should US Treasury pressure re-emerge



The US Treasury market acts as the global benchmark for bond yields, presenting what should be a risk-free return on exposure to invested US dollars

Here's why we should be on alert for some spikes higher in Treasury yields – 'Hyde Version'

The US Treasury market acts as the global benchmark for bond yields, presenting what should be a risk-free return on exposure to invested US dollars. During periods of turbulence, its quality credentials typically facilitate price appreciation, and when there are doubts or worries, investors have tended to autopilot into the safety of US Treasuries. The events post 'Liberation Day' have muddied those waters. Even if only fleetingly (lasting just a week), that safety trade turned into a pain trade.

> Hyde in action: for an exposure in the US 10yr Treasury bond from 7-14 April there was a 6% fall in price and an additional 3.5% fall in the US dollar; a cumulative 10% hit for overseas players. A European-based player invested in the Euro Stoxx 50 would have

returned +6.5% over the same period. That's a cumulative Delta above 15%. This is an experience that will not be unlearnt easily.

Even though US Treasuries have since settled back into a more traditional feel, when we get the next wobbles, the subsequent flight to Treasuries will not be the blindly obvious trade.

The foreign exchange angle also continues to bubble away with an undertone of US dollar vulnerability. For example, there has been a spike appreciation of the Taiwanese dollar, on the theory that it is first on the list of crosses primed to move on a weak US dollar trade. The Swiss franc experienced something similar some weeks back, and many other currencies are up versus the US dollar by more than 8% year-to-date. That includes the euro and the Japanese yen. There's an eye too on the Hong Kong dollar, for instance, as it sits right on its floor, held there on FX intervention. There's always a risk where lower-yielding funding currencies spike, as it exposes liabilities set in them, especially leveraged ones.

That's one side of the risk trade. The other side is the risk of unruly dollar weakness, as that is a clear menace for overseas holders of US Treasuries.

When we talk of a 'Sell America Inc' trade, there are three angles to this. The first is the notion of hurting America. That was the genesis of talk that the Chinese had been sellers of Treasuries, or could be sellers of Treasuries in the future. It does not have to be adversaries selling, it can also be friends selling. Some in Europe have held that out as a means to getting back at America. The second notion is down to self-preservation. The idea here is that if there are enough sellers, regardless of who they are, then the other side of that trade is not where you want to be. The third is down to fundamentals. The US fiscal / inflation prognosis presents that. There's enough here to warrant remaining on 'Sell America Inc.' alert.

Here's why we can first test lower in yields based on a more traditional theory – 'Jekyll version'

That being said, there is another side to the bond story in the months ahead, one centred on the risk of recession. Traditionally, the onset of a recessionary tendency would coincide with downward pressure on bond yields. The theory here is that a slowing environment is typically not an inflationary one, and risk assets tend to struggle on attendant risks to corporate earnings. Even though risk assets of late appear to be in better shape (despite prior scares), that can change quickly. The coming months will be crucial in this respect, with the clearest risk coming from any material scent of recession ahead.

The latter presents a rationale for a downside test to Treasury yields, a more traditional drift lower in anticipation of slower activity (potentially a recession of some description), supported by a rate-cutting narrative from the Federal Reserve. While the Fed is anticipated to get down to the 3-3.25% range, there is every chance that the 10yr Treasury yield slips back below 4% – a typical reaction to concern on the state of the economy. The ability to get too far below 4% would be constrained by the swap spread, currently in the 50bp area (10yr Treasury yield at 50bp over 10yr SOFR). To get much lower, the Fed would need to cut by more than currently anticipated.

European bonds and other markets may diverge, negatively correlating on the Hyde version

There is an important nuance for other core market yields, where any 'Sell America Inc.' theme likely coincides with residual flows into other core markets, especially if the selling of Treasuries is driven by idiosyncratic reasons. In that sense, the likes of European bonds would be recipients of inflows, generating a divergence with US Treasuries (and widening spreads).

Then, for 2026, we could see the opposite where increased fiscal spending and its wider ancillary positives can manifest in relative rises in European yields (likely tighter spreads). For the immediate few months, expect a positive correlation to dominate and yields in the US and Europe to have a downside tendency.

> We don't love a V-shaped view, but it's what we're confronted with. The first half of the 'V' has the 10yr yield heading for 4%, and likely slightly through, as the data deteriorates. The second half of the 'V' is laced with the 'Sell America Inc' risk and US dollar vulnerability. If needed, this is fundamentally bolstered by rising inflation and ongoing deficit elevation. That can take us back above 4.5%, likely settling somewhere between 4.5% to 5%.
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> Clearly, any visit to the latter extreme would be immensely unsettling. The odds are that policy objectives would be massaged in a way to avert hitting 5%, which is why it's more of a risk call than a base one. This type of environment can see a correlation with the European bond market turning negative, and spreads re-widening.

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