Article | 9 April 2018

Rates: Risk asset wobble

3% remains a credible target for the US 10yr yield. But to breach it, a confluence of positives will likely be required

Risk asset wobble acts to pull core rates off their highs

Despite the big wobbles seen in risk assets, US market rates have managed to maintain reasonable poise. Yes the 10yr yield tested lower through March to trough at 2.73%, but it's now back above 2.8%. It is still below the big 3% target, but back to within spitting distance of it. Our view remains intact; at some point in the coming months the 10yr yield will likely approach and break above 3%.

Fundamentals, QE unwind and supply pressures continue to act as upside forces for rates

We'd in fact expect the 10yr to settle in the 3% to 3.5% area, and somewhere within that range is where the cycle peak should mark. The key drivers are three-fold.

Robust fundamentals, encapsulated by, eg, consumer confidence readings that are off the charts, in turn tempting the various measures of inflation higher.

By 4Q this year central banks will no longer be net buyers of government bonds as the ECB tapers to zero and the Fed continues to de-print money.

The US fiscal deficit will be on the rise, which means more US Treasury supply.

So, when the 10yr gets above 3% it will likely be there for at least a number of months. But it may also take a period for us to get there in the first place, as some key headwinds are pushing in the opposite direction.

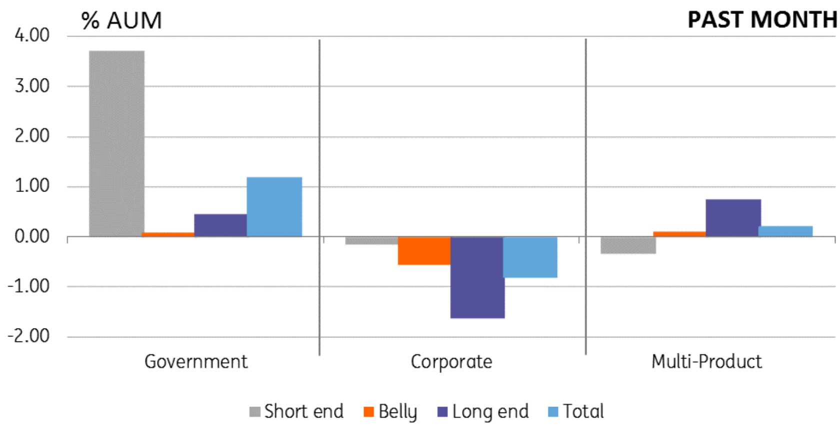
But for now rates have been contained by the trade war narrative in particular

The ratchet higher in US yields has been curbed by a preference for Eurozone market rates to drift lower since peaking in mid-February. This stretched the Treasury/Bund to extremes, and consequently coaxed the US 10yr yield lower. Also, the US 10yr yield got to 2.95% quite quickly in any case, and was due some consolidation. And the morph into a steady drift lower in core yields was facilitated by the trade war narrative. This uncertain backdrop is still playing out, and acting as a constraining factor.

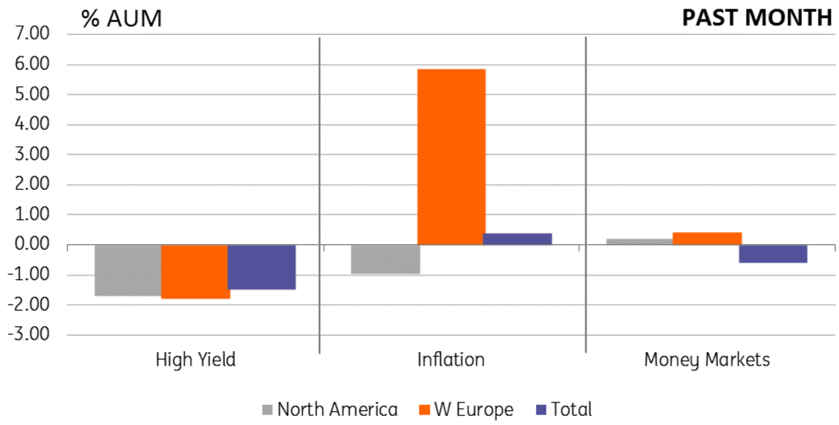
Market positioning shows a discount for reflation

What have market participants been doing in the face of this? There has been a flight into short end government funds and out of long end corporate funds (Figure 11). This implies a duration short strategy – code for positioning for higher rates. Ongoing inflows to W Europe inflation and outflows from High Yield are also thematic (Figure 12). Overall the market is positioning for reflation, higher core rates and wider spreads.

Changes in assets under management – Mar 2018



Source: EPFR Global, ING estimates



Source: EPFR Global, ING estimates

A confluence of positives is required for a break above 3% on the US 10yr

Bottom line, while there is little doubt that contemporaneous macro circumstances are significantly net positive, there are also some quite persuasive naysayers in the wings pointing to issues (e.g. trade war) that can accentuate downside risks to growth. Firm macro prints have assuaged these fears so far, and we expect more in the coming months. Hence 3% remains a credible target for the US 10yr yield. But to breach it, a confluence of positives will likely be required.

This article is taken from ING's Monthly Economic Update, which you can find here.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com