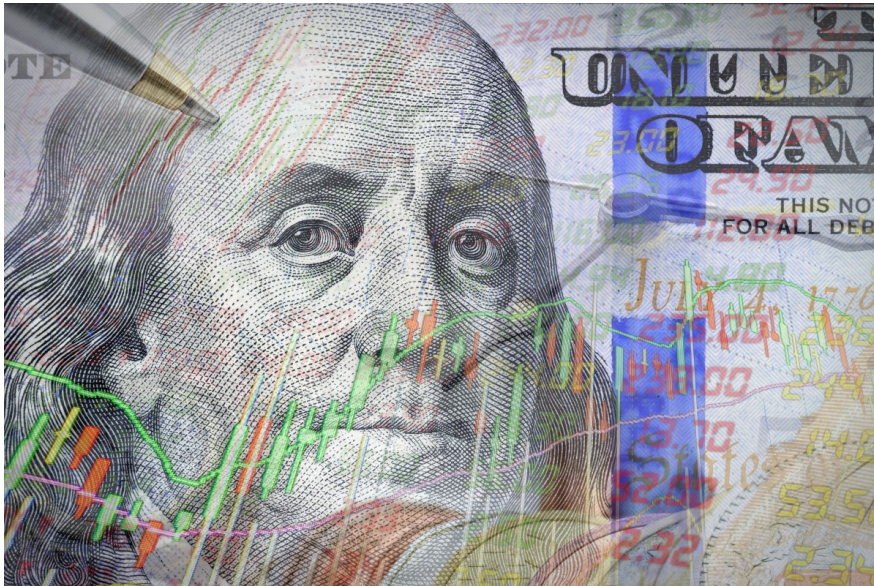


Rates Spark: A 30yr headache

The tail on the US 30yr auction was big. Effectively a 5bp concession to secondary was required to get the paper away. Hence the ratchet higher in yields. The front end too is feeling renewed pressure from the Fed. No easy ride here for players tempted to trade this from the long side post payrolls. We maintain a non-conviction preference to go the other way



Difficult to ignore a 5bp tail at auction

The US 30yr auction tailed dramatically – by over 5bp. The tail on the 10yr on the previous day was largely ignored, at least initially. But a tail this big could not be. Still the reaction was quite spectacular. Things, however, calmed after the impact break back above 4.8%. But still, we now have the 30yr yield in the 4.75% area and the 10yr in the 4.65% area, with the latter well back above the 4.5% level that has acted as a bit of a floor since hitting it after payrolls. In fact, we are now back in the area we were at just before last Friday's payrolls report.

Excess liquidity falling, but value in the 2yr now at above 5%

And as expected, no surprises from Powell at the IMF conference. It's clear that the Federal Reserve wants to maintain a tightening impulse. This makes sense, as any hint of neutrality would hasten a market dash to discount rate cuts. There is also the risk that the Fed is not just saying stuff, but

could in fact hike again if needed. Next week's CPI report is likely to show that headline inflation is homing in on 3%, but the issue is core which will still be in the 4% area, as is core PCE. With inflation here, the Fed is nowhere near caving into the rate hike talk.

The 2yr US yield popped back above 5% following Powell's speech. But if there was an area of the curve where we feel relatively comfortable to be long it's a 5% handle on the 2yr. The funds rate today is 5.33%, only slightly above. And even if there were one more hike, the bigger moves would be to the downside on a one year forward basis. If the Fed gets to 3% by mid-2025 (our view), then the breakeven US 2yr yield is 4.5%. Given that, the 5% handle on the 2yr looks generous, and incorporates much less interest rate risk than longs right out the yield curve.

On the front end, we also saw an historic day of sorts, as the cash going back to the Federal Reserve on the reverse repo facility dropped below US\$1trn. That is still a large volume of excess liquidity in the system, but it has come down from the US\$2.25trn area since the summer in a precipitous manner. A lot of this reflects the build in the Treasury cash balance, from close to zero in the summer before the debt ceiling was lifted, to near US\$800bn now. Going forward, the bulk of the fall in usage of the reverse repo facility will come from ongoing quantitative tightening.

The deterioration in Treasuries liquidity is worth noting and it is worrying

Even though we still have ample liquidity conditions based off these measures, and some US\$3.3trn of bank reserves, there has been a material deterioration in liquidity in US Treasuries. The Bloomberg measure of Treasury market liquidity based off persistent dislocations from fair value is at an extreme right now. It is even more extreme than seen during the pandemic. The big movements seen in long dated yields is reflective of this too, where volumes have been less impressive than the big price movements might suggest. It is tough to stay in the trades in long dates in these circumstances.

Given that the 4.5% level has not been crashed though, we maintain a preference for a heavy market here where yields can test the upside. Part of the reasoning here is a lack of rationale to capitulate lower in long dated yields. That will come, but it's not yet a conviction bet.

The day ahead

The day ahead is light for data. The main focus ahead of the weekend will be on the University of Michigan readings. Expectations are well below average, and are expected to remain so. Inflation expectations are expected to remain on the high side though, with the 1yr inflation expectation at 4% and the 5-10yr expectation at 3%. There are a few Fed speakers too to be aware of, with Logan, Bostic and Daly due to speak. And in the eurozone we expect to hear from Lagarde and Nagel. We are not expecting a lot of fireworks from this lot at this juncture. The (net) hawkish pressure will be sustained.

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