Rates Spark: A bond market looking for validation

Payrolls day is usually pivotal. This one more than most, as the US 10yr has fallen sharply from 5% down towards 4% without material evidence of any labour market recession. We don't have to have one, of course, as lower yields can also be validated by lower inflation expectations. But in the end, it probably does have to happen, or else bonds have issues ...

The key event for the day is the US jobs report, the nonfarm payrolls

Today's payrolls report will set the scene for the rest of 2023

It's payrolls day! And it's a key one. The US 10yr has moved sharply from 5% down to approaching 4%. It really needs some validation of that move from today's report. Or to reverse engineer this, the Treasury market is telling us the number will be weak. But what is weak? The key reference is 150k. That's the replacement rate. Average payrolls in the past few decades have been 130k per month. Anything below these numbers would be "weak", as it would begin to signal a growth recession. This month's number is bolstered by returning strike workers so that the consensus of 190k actually translates to something close to 150k – bang on the crossover point.

Whatever happens, it will set the scene for the week ahead, one that kicks off with supply, featuring the 30yr auction which has had a habit of tailing. Any kind of payrolls “strength” would have to be a problem for this bullish bond market.

And then we have the Fed next week. Payrolls are likely more important

We also have the Fed next week. There may be some interest in the press on money market conditions following the spikes seen in repo around month end and reverberating into the early part of December. This comes against a backdrop where banks' reserves are ample, in the US$3.3tr area. The last time the Fed engaged in quantitative tightening, bank reserves bottomed at a little under US$1.5tr and there was a material effect felt on the money markets. It’s unlikely that we'll get anywhere near that this time around. Bank reserves will almost certainly get below US$3tr and possibly down to US$2.5trn.

The Fed will want to get liquidity into better balance as a first port of call, but beyond that, it won’t want to over-tighten liquidity conditions. Taking this into account, QT is likely to end around the end of 2024. In the meantime, the clearest manifestation of quantitative tightening is to be seen in falling liquidity volumes going back to the Fed on the overnight reverse repo facility. This is now at US$825bn, but is set to hit zero in the second half of 2024. Whether Chair Powell gets drawn into this will likely be down to whether the press wants him to - they will probably have to ask the questions(s).

In terms of expectations for market movements, we doubt there will be much from the FOMC alone. If, as we expect, the Fed sticks to the hawkish tilt, and does not give the market too much to get excited about, then expect minimal impact. As it is, the structure of the curve, as telegraphed by the richness of the 5yr on the curve, is telling us that a rate cut is not yet in the 6-month countdown window. That will slowly change, and we’ll morph towards a point where we are three months out from a cut and the 2yr yield really collapses lower.

It's unlikely the Fed will change that at this final meeting of 2023, though, and they won’t want to. Expect much more reaction from today’s payrolls report.

Today's events and market view

The key event for the day is the US jobs report. The consensus for the change in non-farm payrolls has slipped somewhat to 183k, which compares to the 150k reported last month. The unemployment rate is seen staying at 3.9%. The other release to watch today is the University of Michigan consumer sentiment survey. It is seen improving marginally, while the inflation survey is expected to ease to 4.3% on the 1Y horizon and 3.1% on the 5-10Y.

There is not much on the eurozone calendar, but the ECB will reveal how much of their outstanding TLTROs banks choose to repay ahead of time at the end of this month on top of the €37bn that will mature.

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