Rates Spark: Can payrolls hang in there?

Payrolls day remains *the* most important one for markets. Even going into most pivotal Fed meetings we typically know what's going to happen. For payrolls, we think we know. And even if we did, the print itself can have a perverse effect. The big fear is we get a really bad one sometime soon. Feeling bullish? Fair. But, weak payrolls also means a higher deficit

A super weak payrolls report can create more problems for Treasuries than face value suggests

There's quite a soft market expectation from Thursday's payrolls number. At around 100k, that's some 50k short of the normal replacement rate in the 150k area. As a consequence of this shortfall, the unemployment rate is anticipated to rise to 4.3%. And this combination comes against a backdrop of rising jobless claims, and the beginnings of a notable strike higher in continuing claims. Neither of these are at real danger levels, but they are indicative of a slow creak in the labour market. The evidence does not point to a negative print (fall in employment), but it is noteworthy that Wednesday's ADP report did in fact print negative.

What is quite remarkable is the juxtaposition between this slowing macro environment versus a degree of relative optimism in the risk assets space. Equity markets appear to be cheered by the

prospect of Fed cuts to come, and high yield spreads are back down at levels that point to a reduced default risk (in turn impliedly suggesting not a significant recession risk). From a US 10yr Treasury perspective, any sense of super weakness in the payrolls report would present a recipe for a downward lurch in yields, on a theory that the economy is shuddering and the Fed may need to accelerate its rate cutting agenda. By the same token, a number of between 100-150k would be deemed tolerable enough, and one not requiring deep worry on the economy.

That all being said, we also can't ignore the Big Beautiful bill and the fiscal legacy of it, which is an elevated fiscal deficit. For now this is being broadly ignored. But bear in mind that macro weakness would also mean a shortfall in tax receipts, adding to upward pressure on the fiscal deficit. That's an important sting in the tail for Treasuries to consider, from a supply perspective, and an implied credit rating one. On top of that, we'll see upward pressure on headine inflation rates in the coming months too as the tariff effects begin to bite, which is another issue for Treasuries to be concerned with. Remember, 10yr SOFR today is 3.7%. The question is whether that is sustainable should US inflation head towards 4% through the third quarter (which we think it will). That's the complication. The gut feeling is we should be bullish on Treasuries on macro risks. But the head is screaming that this may not be the way to go this time around.

Fiscal concerns, (another) UK edition

Fiscal concerns around the UK sparked noticeable bear steepening of the gilt curve with 30y yields rising by as much as 20bp, some 12bp more than Bunds and Treasuries that day. It was a reaction to the latest headlines around the position of Chancellor Reeves as Prime Minister Starmer failed to provide his backing - a watered-down welfare bill had earlier this week brought into question her fiscal consolidation plans.

This also marks a stark reversal in the dynamics relative to Bunds. Gilts had previously managed to tighten versus Bunds over the past month and particularly the past week. That can be in part rationalised by Germany's outsized borrowing plans recently outlined by the government pressuring Bunds, and gilts receiving tailwinds from Bank of England commentary suggesting that the central bank's active gilt sales could be scaled back in the future. However, the main driver of the spread tightening for lack of other news – until now - was a relatively higher correlation of gilts to US Treasuries, and the latter experiencing a rally on the back of softer data and dovish Fed voices.

This latest episode highlights markets' ongoing sensitivity to the trajectory of government finances. It is something that we think also puts US Treasuries still at risk of a sell-off episode, though we are now experiencing a more macro-driven market dynamic. The German government's plan for new borrowing of €850bn until 2029 are already pressuring Bunds, though crucially the country is looking at a very different starting point. With the new 10y Bund benchmark that was launched on Wednesday the 10y Bund yield is now 4bp above the swap rate. We think in the longer run Bunds can still cheapen as the supply pressure builds. A further 10bp increase of the spread looks possible taking into account not only the rising net issuance but also the declining bond portfolio of the ECB.

Thursday's events and market view

The US will release its official job numbers a day earlier than usual.This is a key input to the recent discussion around the possibility of accelerated and deeper Fed cuts. The consensus expectation is still for a 110k increase in non-farm payrolls, with estimates ranging from 70k

to 160k. Even after the surprisingly weak ADP figures Bloomberg's whisper number (basically every Bloomberg terminal owner can provide his estimate) slipped to only just below 100k. Meanwhile, the unemployment rate is seen ticking slightly higher from 4.2% to 4.3%. Other US data to watch is the ISM services, which economists see climbing above 50 again, if only barely so.

The eurozone will see the final services and composite PMIs for June, while the European Central Bank publishes the accounts of the June policy setting meeting.

In primary markets Spain and France will auction bonds: Spain from 3y out to 15y maturities (up to €6.75bn including linkers) and France from 10y to 30y maturities (up to €12bn).

Author

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

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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