Rates Spark: Down but not out

A cumulation of weaker data and dovish headlines in developed markets has pushed yields lower on Tuesday, taking the 10Y US Treasury close to 4.10%. We are not convinced that rates can only go down from here. Risk sentiment remains frothy and central banks are in a near term holding pattern – likely to be confirmed by Powell on Wednesday

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Yields were testing lower on Tuesday against a backdrop of mixed data. The move lower kicked off in the European session with weaker French industrial production data. Smaller upward revisions in the PMIs later did not move the needle.

More movement was seen against the backdrop of a UK headline stating that Chancellor Hunt was planning a 2% point cut of the national insurance – a central measure of the spring budget to be announced on Wednesday. This has provided Gilts with room to outperform since the option of wider tax cuts would have been a more costly and come with a potentially more inflationary impact and headaches for the Bank of England.

In the US, the ISM services release handed markets a mixed bag with a disappointing headline but improving business activity and new orders components. Something the market may have been more sensitive to ahead of Friday's jobs data was the employment component dipping into contractionary territory.

The cumulative result of the above was 10Y Bunds testing the 2.3% level and US 10Y Treasury yields falling towards a low of 4.11% amid a second day of curve flattening. We are still not fully convinced that rates can only go down from here. Despite some softness in equities over the last session, the overall risk backdrop still looks frothy across a wider set of indicators from spreads to volatility.

Central banks' near term holding patterns should be confirmed this week

In the end, it will come down to the data. The market appears to have become more sensitive to some of the survey data of late. And especially in the US survey data has given a different impression of the underlying economic strength than the official data with its bumper growth and jobs figures – on the latter we will get the update this Friday. But official data is what the Fed has to use as its main guide, and it signals a hold for now. That tension in the data is what can keep curves flatter before we eventually get to a resteepening when rate cuts become more imminent.

Wednesday Fed Chair Powell testifies before Congress, and we do not expect a big shift in language. The central case should remain that rates have peaked, but the economy remains robust and more evidence of inflation returning to 2% needs to be seen before rates are cut. To us it would be another confirmation of a holding pattern over the coming months of central banks. The ECB should provide us with their version at the policy meeting on Thursday.

Wednesday's events and market view

Wednesday will be a busy day in data, though less so in EUR markets where the only notable release are the retail sales. Headlines ahead of the UK Spring Budget may have taken the edge off this key event Gilts.

The main focus should be the US. In data markets should get a first feel on the labour market with JOLTs job opening numbers and the ADP payrolls estimate, even if the latter is of questionable use in predicting Friday's official data. Later in the day the Fed will then release is Beige Book. The highlight will be Fed Chair Powell's testimony to Congress.

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