Rates Spark: How to spend it

We show that the Treasury market is not discounting a recession currently – even with the US consumer somewhat navel gazing. Still spending, but not thrilled about the future, it seems. In the UK, the Spring Statement lends itself for another look at fiscal trajectories. In fact, Germany compares rather well, despite the planned spending splurge

Still playing the 4.25% to 4.35% trading range for the US 10yr till 2 April

The US consumer is an interesting beast. If we're to believe the latest evidence (from the Conference Board), they are cocker-hoop on current conditions (134.5), but really down in the dumps about the future (65.2). And on balance, not in a bad way, but hanging in just about (92.7 overall vs 100 as a neutral reference). The 80 area (and below) is where the consumer has really caved. The area between 90 down to 80 is the dodgy zone where things can begin to topple. Basically, we're now teetering, but not quite over the edge. What we do know is, if the consumer stops spending, the US economy is in a spot of bother. Enough in this for Treasury yields to re-test lower on Tuesday as a theme, capped off by a decent 2yr auction bolstered by a strong indirect bid and a negative tail (effectively came through secondary; not quite accurate, but that's the way to view it).

At the same time, this bond market is *not* discounting a recession. There is a basic discount that the Fed cuts by some 75bp, but lands at above neutral. And the forwards continue to discount upside to market rates beyond that. Look far enough out the forward profile and you'll find Treasury yields at above 5% and SOFR rates at above 4%. The latter are far from perfect predictors, but that they are at the same time an accurate breakeven as to what current curves are impliedly discounting. And that's why we assert that this market is not actually discounting a recession. Even if there were a recessionary tendency, and we had decent interest rate cuts, the jury is still out on what that should mean for longer tenor rates. Traditionally they should be forced lower. But as we've noted before, the elevated fiscal deficit and stubborn inflation combination remain unresolved issues. And the underlying tarnishing of America Inc. (internationally) can cut in many different ways.

We still see the US 10yr yield as trading between 4.25% to 4.35% for this week, and at least into 2 April when we can finally get some steer as to what it all means, even if only as a first pass-through with more to come. We need to get there first though.

Germany's new fiscal trajectory still compares well

Tariff headlines, data and of late also European Central Bank commentary again continue to inject volatility into longer yields. It has taken 10y Bund yields on another roundtrip above 2.8% and back with the curve maintaining a steepening bias. As for the latest ECB commentary, it was more guarded than the surprisingly blunt assessments from doves earlier – Kazimir, Muller and Vujcic all left the April decision more open on Tuesday.

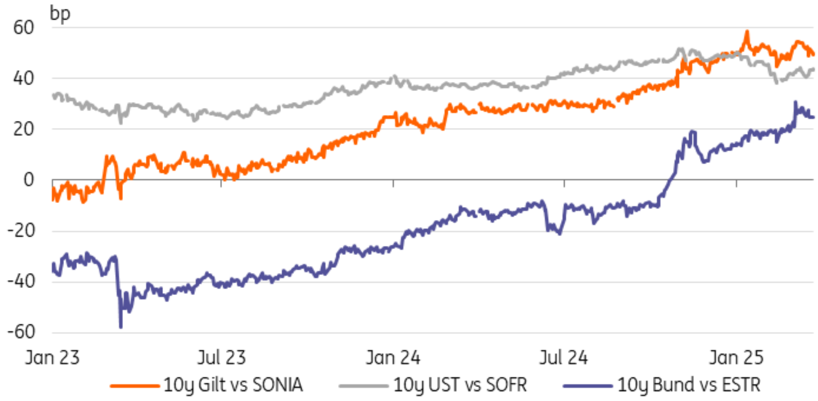
Where we have seen more stabilisation is in Bund valuations versus swaps. 10y Bunds are yielding again ‘only’ 9bp above swaps after having peaked around 18bp early in March. On longer history charts, one would be tempted to see this merely as a return to a more general cheapening trajectory that began in October 2022.

And it has been a trend not confined to Bunds, but also seen elsewhere in US Treasuries and UK Gilts. Gilt valuations versus SONIA have also regained some ground after the initial cheapening on growing defence spending prospects – the government had offset these with cuts to foreign aid. Nonetheless, the overall more range-bound levels since the start of the year will likely see more scrutiny on Wednesday on the back of the government’s Spring Statement.

The US is where bonds have actually performed versus swaps more noticeably this year. Despite some recent cheapening 10y Treasuries are still 6bp richer versus SOFR compared to the start of the year. This is against the backdrop of hopes that DOGE can make meaningful savings, regulatory relief for banks and a clear focus of the Treasury secretary on the 10y yield. However, market concerns are not fully dispelled, and this is also reflected in a commentary by the rating agency Moody’s on Tuesday. In particular, the agency saw “diminished prospects” that the central role of the dollar and Treasury market would “continue to offset the widening fiscal deficits and declining debt affordability.” It is one reason why we still have a longer run 10y yield forecast of 5%.

Circling back to Bunds, even in more pessimistic scenarios calculated for instance by the IW, Germany’s debt would end up at 90% of GDP by 2037, which is well below the levels of the US (123%) and the UK (104%) currently. As such extrapolating spread-over-OIS trends to converge with these peers seems somewhat pessimistic, especially more near-term as the funding impact of the fiscal decisions is likely to be felt only later this year. But we would also point out the implications of such a trajectory for broader EGBs – the weighted average spread of 10y EGBs yields over OIS at c.80bp is already well above what we see in the UK and US.

Government bonds have been on a cheapening trend versus risk free rates



Source: Refinitiv, ING

Wednesday’s events and market view

In the UK the focus will shift from the inflation data in the morning to Chancellor Reeves' presentation of the Spring Statement. She is expected to reveal cuts in welfare and future departmental spending growth. The market’s main focus will be on the implications for the gilt remit, where around £300bn in gilt issuance is forecast for the next 12 months. Gilt remit and updated OBR forecasts are usually released shortly after the speech, which this time could be around 14:00 CET.

In other data the only highlight is the US durable goods orders. Central bank speakers to follow are Kashkari and Musalem from the Fed and in Europe Villeroy and Cipollone from the ECB.

Primary market supply will come from Italy auctioning 2y bonds and linkers for up to €4.5bn, and Germany auctioning 15y and 20y bonds for €2bn. The US Treasury sells new 5y notes and FRNs (US$998bn).

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