Rates Spark: Market discount shifts to un-discounting some recession risks

"What recession?" the market seems to be screaming, with ongoing subdued US jobless claims earlier helping. The trade deal with the UK pushed in the same direction, but was not determinative in our opinion. A deal with China would be a much bigger deal, and that's what the market is really reacting to, and why it could reverse if there were disappointment

Markets now seem to have less US recessionary fears

US Treasuries not pointing to a recession

Pricing was not great on the 30yr auction. But at the same time is was a fast market into auction, with yields on a persistent rise, which likely acted to add to an overall concessionary bid at auction. Beyond that, the breakdowns between indirect, direct and dealer bid did not have a big story to tell. The cover was a tad tepid, but in the end safely away. The underlying up-move in yield has been the story of the day, on a risk-on underpinning. The 10yr yield is now closing in on 4.4%. It appears that the market discount is moving away from a blind recessionary discount. The 2yr yield is also well up on the day, heading towards 3.9%, on a day where the curve has simply shifted higher.

Heading into the end of the week in a pretty good mood from a risk asset perspective, and by extension Treasury yields emboldened to test higher. CPI inflation has some decent cover from a favourable base effect, which can allow chunky 0.3% month-on-month readings to go unnoticed, as they don't push up year-on-year rates (2.4% headline and 2.8% core), that is unless we were to get 0.4%. Definite tone change through Wednesday.

A UK theme dominated through Wednesday on a rate cut and a trade deal of sorts

The Bank of England made its cut, as was already widely expected, but the communication did not offer the dovish flavour markets were looking for. Sterling rates had turned more dovish in the wake of 'Liberation Day' and followed US rates lower. The script of the Bank, however, did not move away from its “gradual and careful” approach and the baseline therefore remains cuts at a quarterly pace. Markets still price in a 25% rate cut at the June meeting, but we think the next cut will have to wait.

Markets will be watching inflation and growth data closely for the possibility of an accelerated easing trajectory. Services inflation remains hot, but should be coming down. The growth implications from the trade tensions may be relatively limited, however, especially after Trump’s announcement of the signing of a deal just after the BoE meeting.

The trade deal with the UK may be an important first omen to striking more deals with US trade partners. Little is known about the details, but markets are appreciating that the momentum is heading in the right direction again. The bigger market moves on positive trade news could eventually come from the eurozone, which is more vulnerable to the tensions than the UK.

The Bund-swap spread is not back to the levels from before 'Liberation Day' yet, but lower market volatility could already help swaps outperform bonds going forward.

Friday’s events and market view

Little data is scheduled, but plenty of central bankers will take the stage. From the Bank of England we have both Govenor Bailey and Pill speaking, which will be interesting just a day after the meeting. The ECB speakers include Simkus and Schnabel, while among the Fed speakers we have Williams, Barkin and Goolsbee.

Author

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

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Disclaimer