

Rates Spark: Market rates are already discounting a large chunk of rate-cut talk

The 4% 10yr Treasury yield looks a little high relative to the 3.6% briefly touched this week and the rate-cut story ahead. It's not though, as there are reasons to validate higher yields in the future. Nearer-term, market rates can ease lower on further risk wobbles and cut delivery. But there's not much room to the downside, not in a structural sense



Implied rates volatility remains high

At face value markets seem to be calming down, but forward-looking volatility measures tell us that we are not yet back to normal. The 3m10y implied rate volatility measure is well above the lows in July, which indicates that markets still anticipate heightened volatility of 10y yields over the coming months. Higher expected rates' volatility will also prevent European government bonds and swap spreads from tightening back to the lower levels seen last month.

With growth seemingly cooling down, the direction of rates is lower, but the potential pace of central banks' easing remains uncertain. Inflation is sticky, and economic numbers, notably in the eurozone, paint a mixed picture, adding to the challenge of central banks. Add fragile risk appetite to the equation, and the formula for high rates' volatility is here to stay for now.

To bring down volatility from here would require a clearer direction about the US economy, which could take many more data points. Yesterday's US jobless claims number underlined how sensitive global markets are to single readings, with the 10y Bund yield up 3bp on just a slight positive surprise. With that in mind, next week's US CPI is the reading to watch for the next move in global rates.

Medium-term bear issues to be aware of

There was a remarkable market reaction to pretty much a "nothing" claims number yesterday. It came in lower than expected: 233k initial claims. But the subsequent 5bp up-move on the 10yr yield tells us that this market is a tad rudderless and, in consequence, quite jumpy. Clearly, there was a body of opinion out there expecting a significant rise in claims as the economy struggles. An actual fall, then, is the opposite outcome. Last week's payrolls number was also not a collapse. It was just a weaker-than-usual reading. The market is extrapolating that into a hard landing hence the wobble on Monday and the ongoing angst since.

The bottom line here, though, is an economy that is weakening but not collapsing, and the financial system is working fine, so there is no need for panic from the Fed, even if equities were to decide to wobble again. In terms of fair value for the 10yr yield, the funds strip has the rate bottoming at just above 3%. We need to add at least a 100bp curve to that, which gives me around 4% for the 10yr fair value level. We can go below that. We've been there most of this week, but just remember that's an overshoot to the downside. We can, in fact, overshoot back down to 3.5% in the 10yr as the Fed starts cutting. But beyond that, that 10yr yield gets back up to a 4% handle, and can easily rise to 4.5%+ eventually.

Today's events and market view

On the last day of this week, there's not much notable data scheduled. Germany and Italy will publish final CPI numbers for July, which usually don't deviate much from the preliminary readings earlier.

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