Rates Spark: New cycle highs for US Treasury yields

Defying geopolitical tensions, US Treasury yields out to the 10Y tenor have marked new cycle highs, but that may well just be waypoints on a march higher. EUR rates get dragged higher alongside but lag amid greater exposure to Middle East tensions with dampened risk sentiment also playing into already fragile sovereign spreads

New cycle highs for US Treasuries out to the 10Y tenor

Rates continue their march higher, with UST yields out to the 10Y tenor marking new cycle highs with the aforementioned coming close to 4.93%. The theme remains unchanged with economic resilience as the underlying driver, but there were no new catalysts to really lay a finger on over the course of yesterday's session. Late in the day, the 20Y UST auction that many had feared had actually seen good demand, and looking at the Middle East, one does not really get the feeling of easing tensions. Oil prices, for one thing, remain on the higher side.

For today, many will look forward to Federal Reserve Chair Jerome Powell's speech tonight and whether he chimes in with some of the more moderate tones of late that had pointed to the steep rise of longer rates doing some of the Fed's work. The need for drastic communications change looks limited, though. With regards to the upcoming meeting on 1 November, it does not look like the market needs any particular guidance. Pricing only a minimal chance for a hike, minds appear largely made up. Guidance beyond the upcoming meeting is unlikely to change very much as we see little reason for the Fed to give up optionality for a further hike.

The Fed's Christopher Waller yesterday argued there was good reason "to wait, watch and see" how the economy evolves, but more policy tightening could be needed despite higher long-term rates if the economy continued to prove strong and inflation stabilised or even reaccelerated.

EUR long end rates get dragged higher, but lag amid risks

European rates get pulled higher alongside the US, although the higher-than-expected UK CPI data did add a bit of a local spin. That said, they still lag behind the 10Y UST-Bund spread which is approaching 200bp. EUR rates are more exposed to the tensions in the Middle East. This more fragile risk sentiment is also reflected in the widening of sovereign spreads within the eurozone. The key spread on everybody's mind is those of Italian bonds, where the 10y spread over Bunds has moved further above the 200bp mark.

While likely to pause on hiking rates further, the European Central Bank could shift the focus to its balance sheet and may kick off a more formal discussion on ending the Pandemic Emergency Purchase Programme (PEPP) reinvestments earlier at the upcoming policy-setting meeting next week. While some officials are reluctant to admit that Italy's bond spreads will have a bearing on any future decision, Ireland's Gabriel Makhlouf stated they could very well be a focus. There is good reason to tread carefully as flexible PEPP reinvestments currently form the ECB's first line of defence against bond spread turmoil.

In the near term, Italy faces scheduled reviews of major rating agencies starting with S&P this Friday. Currently, S&P rates Italy at BBB with a stable outlook, but following the government's loosened deficit plans, the stable outlook seems vulnerable. The key date, however, will be the review by Moody's on 17 November, where Italy currently sits at the lowest investment grade rating with a negative outlook.

Given the potentially dragged-out ECB debate about speeding up quantitative tightening and lingering rating risks, the room for Italian spreads to recover looks limited.

Today's events and market view

Upward pressure on rates is maintained by the resilient macro outlook and, for now, also defies geopolitical tensions.

The calendar looks more interesting today, with the US initial jobless claims being seen as a more contemporaneous indicator of labour market health than the monthly jobs data. We will also get the existing home sales numbers and the publication of the Conference Board's leading indicator. But Fed Chair Powell's speech later in the day will likely be regarded as the main event.

European primary government bond markets will be busy with French and Spanish auctions, as well as the syndicated triple-tranche sale from Austria with a new 7Y bond and two long-end taps.

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