

## Rates Spark: No liberation for volatility

The swash-buckle tone being adopted by the Trump administration now generates more apprehension than confidence. We'll know more as we progress through "liberation day". Meanwhile, eurozone risk sentiment has deteriorated, but things could still worsen. We expect volatility to stay for weeks as retaliatory measures build



Risk sentiment is under pressure ahead of the Trump tariff announcements on 2 April

### Treasuries to take their cue from risk assets on Wednesday, and then it's down to the details

Treasuries are viewing the complex ahead as glass half empty for macroeconomic activity. Survey evidence continues to prompt that reaction, and the swash-buckle tone being adopted by the Trump administration now generates more apprehension than confidence. We'll know more as we progress through 2 April (so-called liberation day). It's really tough to call how the bond market will take the tariff story on the day, partly as tariffs are also broadly acknowledged to contain a not insignificant price rise / inflation risk.

As a one-day trade, we'll take our cue from the risk asset space, and in particular equity markets. We don't love doing this as we think the bond market is "smarter", and more long term in thinking. But if we go risk-off in a big way on the day, it's hard to see bond yields rising, as there would be a flight into bonds. And the reverse if the tone is sell (or buy) the fact. Then bond yields rise on a

theory that risk assets take the news well and decide to rally, taking a bid out of bonds.

The fallout over subsequent days will be determined by the details of what happens on Wednesday. But distilling through the fog, it does feel that Treasury yields are in a mood to test lower still for a bit, trading off the growing recession risk being priced from a whole array of weak-leaning survey evidence, with tariffs acting as a tipping point. This needs to be dis-proved by events before Treasuries can start to latch on to the sticky inflation / elevated fiscal deficit narrative that sustains a bearish tint that can come back into play in due course.

For now though we're still looking lower in yield. The only caveat is the floor we identify at around 3.5% for front-end rates (e.g. 1mth SOFR). That plus a 50bp 10yr swap spread pitches 4% as something of a floor for the 10yr Treasury yield. If Treasuries really want to rally, that "floor" needs to be lower. To get lower, we'd need to have a greater recession risk. That's the direction of travel, albeit the case for outright recession has not been fully made as of yet.

## **Eurozone market sentiment under pressure and potential to worsen further**

European risk assets have been doing relatively well since Trump's election, although sentiment has turned more pessimistic over the past week. Implied equity volatilities look elevated compared to the beginning of this year, but don't look stretched yet when looked at from a longer horizon. Similarly, credit spreads are wider, yet still tight by historical standards. This suggests that risk sentiment in the eurozone still has more potential for deterioration if Trump takes a more aggressive turn than expected.

The rates impact from the announcements is most likely to be felt by the back-end of the euro curve. The front-end already prices in a 1.75% landing zone for the European Central Bank, a handle which we deem difficult to break through. Expectations of increased defence spending and a more hawkish ECB should prevent markets from pricing in more easing over the coming months.

If anything, a broader risk-off episode would bring down rates further out the curve and could undo some of the recent steepening. Bunds remain the safe asset of choice, although previous tariff threats have shown little move in the Bund swap spreads. One reason for this could be that Germany is relatively more exposed to US trade than other EU countries. But the recent outperformance of Bunds against swaps suggests that this is still the best hedge against a shock to global risk sentiment.

Whilst from a structural perspective we think 10Y rates should drift higher by the end of this year, the current environment argues for a more bullish stance. Tomorrow isn't the end of the trade wars saga, if anything, this may just be the beginning. Even if Trump comes out softer, volatility will reign for the time being and the retaliatory announcement will probably trigger headlines for many more weeks.

### **Wednesday's events and market views**

Trump's announcement of his tariff plans will commence at 3pm Washington time, which means European markets will already be closed. Before that we will have US data on factory orders and durable goods, which will be watched given the recent data disappointments. Having said that, these are unlikely to move markets with "Liberation Day" taking centre stage. From the ECB we also have Schnabel speaking about reviving growth in the euro area.

Given broader EU spending ambitions, we're curious to hear the ECB's view in relation to this.

Issuance includes Germany with a 10y Bund for €4.5bn and the UK with a 10y Gilt Linker for £1.6bn.

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