

Rates Spark: Not stretched enough yet

Longer tenor market rates want to go up, and curves want to dis-invert. We expect this to continue. Even bouts of risk-off have struggled to temper the upmove, and new excuses are found daily. The latest is the higher oil price. But the underlying impulse has been there for a while, centred on sticky inflation and a downsizing of future central bank rate cuts



Level of 3% for the Bund yield and then 5% for 10yr Treasuries still on the cards

It's proving to be a rough month for bonds, with core product doing worst. A clear bear market in government bonds. And it has had little to do with imminent central bank rate hike fears, as the Fed is practically done, and likely the European Central Bank too. The issue is not about rising official rates. It's more about capacity to cut, and here the market has continued to downsize the extent of rate cuts in 2024/25. That raises the implied floor for both US and eurozone market rates, and continues to pressure longer tenor rates higher. There has been little out there to negate this theme. If anything, activity data has tended to shave firmer than expected and inflation data has been a tad firmer than expected.

There are factors pushing in the opposite direction too. In the past week Germany cut its issuance

estimate for the fourth quarter, which is a supply positive (lower issuance). US auctions have been taken down quite well so far, in the 2yr and 5yr, this week. So there is demand out there. Demand for corporate bonds also remains firm as investors eye decent all-in yields. And in the US the imminent prospect of a (partial) government shutdown means a dampening in spending and activity. Not by much. But enough to be felt. The fact that new macro data won't all be published due to the shutdown means the Fed likely won't hike, as they can't fly blind.

But overall the dominant impulse for market rates is for a push higher to continue. Most of this is coming from the back end, and in particular the benchmark 10yr area. Hence curves are steepening (dis-inversion), as front ends look steady. We think this continues; ongoing dis-inversion, and curves lifting from the back end. The 10yr Bund yield has a (future) 3% handle written all over it, and 5% for the 10yr Treasury yield is looking more probable by the day. This bear market continues to be directionally led by Treasuries, and the risk-off tone in equity markets has not materially hampered it, partially as investment grade credit remains so well bid, and acts as a compressor.

And so far any downward pull from the US government shutdown have been overshadowed by other factors. There should not be a huge Treasury impact from the shutdown in any case. Although it can become significant should it last for more than a month.

Here's how a government shutdown might impact financial markets

The first thing to note is this is different from the debt ceiling debacle that struck some months back. A key element then centred on the risk that the US Treasury could run out of cash and not be in a position make coupon and redemption payments on government debt, which in turn risked a technical default and potential significant instability on financial markets. In the extreme it could have taken the system down. It was also possible back then that parts of the government could have been shut down to help prioritise the servicing of the debt. In the event, these extremes did not occur, as the debt ceiling was eventually suspended (albeit a tad too close to potential default for comfort).

The government shutdown that we are talking about here is different, at least in terms of its impact on Treasuries. The Treasury can continue to issue debt to raise cash, so there is no risk to the payment of interest or redemption payments on government debt. Hence there is no risk of default on the debt. The important nuance here is the Treasury has the cash. It's just that they don't have a legal right to spend it beyond the end of September. For spending to continue unfettered into October, the appropriate spending bill(s) need to be passed by Congress. Only the parts of government impacted by the specific spending bills are impacted, but that is wide enough to cause considerable pain to many government employees or social security recipients.

The impact of a shutdown of some parts of government on financial markets is mostly centred on the dampening effect it has on economic activity. As a stand-alone issue, this should place downward pressure on Treasury yields. And the degree of severity would depend on how long the (partial) government shutdown lasts. There is also the possibility that risk assets could fret as an element of macro uncertainty is thrown into the equation. That too would likely push cash into bonds and money market funds (and out of risk assets). Importantly though, there is no material incremental default risk for Treasuries, and so the financial system should not come under pressure.

There is a technical dimension to this too. To the extent that the Treasury continues to issue on bond markets, and then spends less of the cash raised, there is a tightening of underlying liquidity conditions. This can act as a force of upside to ultra-short term rates. It should not be significant, but at the margin acts as something of a counter-weight to the downward pressure on (longer tenor) market rates. But it should not be a dominating influence. Either way there should not be a huge impact either way, provided it does not get out of hand in terms of longevity of any (partial) government shutdown.

The day ahead

In the US the 7yr auction will complete the re-funding run for this week. Not a massive duration test, and so should be fine. The big hitter on the data front is the core PCE price index. It's currently running at 3.7%, and the market is expecting it to be unchanged at that rate for the second quarter. We fear that it might just nudge higher, based off other inflation data that has surprised a tad to the upside through the second quarter. We'll also keep an eye on jobless claims, still running at close to 200k, and so tame. And pending home sales should be weak. In the eurozone there is a inflation focus, with CPI releases coming from right across Europe, likely featuring more evidence of sticky inflation conditions.

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