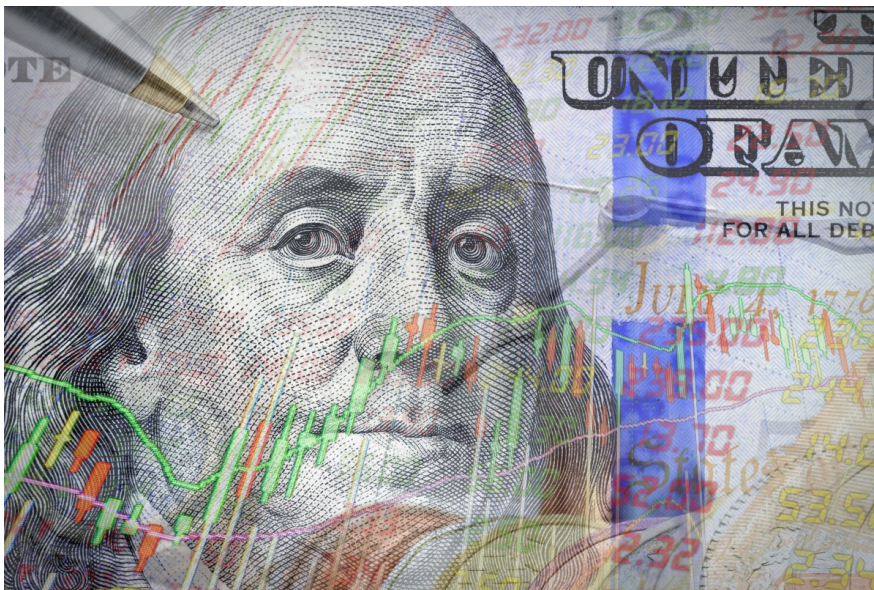


Rates Spark: Rate cut momentum is sustained

In ten days we'll get a very subdued PCE deflator report, and that will harden the build of a rate cut discount for September. Treasury market participants know this, as they snapped up the 20yr auction. Other data are just about playing ball too. There is another side to this being ignored (-20bp term premium vs fiscal unknown), but that's for another day



Glass half full theory to harden the September rate cut discount very much in place

The US 10yr Treasury yield is back in the 4.2% area, and looking down. We continue to eye 4% as a viable target. Since the May CPI data there has been enough in the subsequent data and events to sustain the build in the rate cut discount. There was a 0.0% month-on-month reading for headline inflation then, and in about ten days the market is looking for 0.0% MoM for the PCE deflator, and 0.1% MoM for core. These are a run of very tolerable inflation readings, and in fact continues the year-on-year tendency for 2Q into 3Q inflation data being more subdued than in the first quarter. These data are supposed to be seasonally adjusted, but enough said about that. Bottom line they

are helping the bond market to feel more secure about rate cutting season ahead.

Even the 20yr bond auction was snapped up, at a near 3bp premium to secondary. Not exactly a key reference point on the curve, but still this continues a decent run of taking down big auction sizes, and shows there is demand for duration. The flows data that we track tells the same story. And in fact there is ample liquidity still in play. Cash is going into bonds, but it is also going into money market funds (continuing to top US\$6tn). And risk is hanging in too. Although some emerging markets are struggling, more on idiosyncratic factors than systemic ones. That said, the sequence of hits to individual Latam markets last week did smack of a concerted flight to core theme.

There is an interesting juxtaposition with very poor Treasury market liquidity to take into account too

And there are other issues to be concerned with too. While on the one hand we acknowledge that Treasuries typically rally into the discount build and delivery of rate cuts. On the other hand, we see a -20bp term premium on the 10yr yield, suggesting no risk premium being attached to the fiscal story. At some point this will change. For now though the clear focus is on the hardening of the rate cut discount. We suspect that once we get a few cuts, bond markets will begin to focus a bit more on the weight of supply, acting to steepen the curve from both ends.

Reverse repo balances below US\$400bn, and primed to structurally fall ahead

The back story of easy liquidity conditions lies in the elevated levels of bank reserves. They remain in the US\$3.5tn area, despite the ongoing policy of (now tapered) quantitative tightening. The US Treasury has been spending down tax receipts in the past month or so, acting to push liquidity back into the system. That's helped sustain a decent liquidity environment, despite the fact that the balances going back to the Fed through the reverse repo facility have broadly flat-lined in the US\$400bn area. This important safety valve has effectively been on hold, and if it remains on hold it would likely correlate with falls in bank reserves in the months ahead, tightening the liquidity feel.

However, we're of the opinion that the reverse repo balance will resume falling in a more persistent manner in the coming months. In fact it would be optimal if that were the case, as this facility is actually primed to take excess liquidity out of the system. As liquidity gets tightened through quantitative easing, it should see this safety valve be required to do less work in the future i.e. volumes should fall.

A corollary of this it would take longer for the heat of quantitative tightening to be felt in bank reserves. In a way this is a conflict to the rate cutting agenda, if anything it is in fact acting to delay it. We're not calling for this; but we'll keep an eye on it.

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