Rates Spark: Rates markets risk overreacting

Following a weak jobs report, UST yields briefly hit 3.65% starting the new week, the lowest since the second quarter of 2023. The 10Y yield also dipped to 3.66%, causing a brief dis-inversion of the 2s10s curve. Despite lingering market concerns, we see no need for emergency Fed cuts, but the 50bp narrative may stick

Volatile market moves helped UST 2s10s briefly dis-invert

Following Friday's weak jobs report, the move lower in US rates extended while losing much of its initial momentum. The 2Y US Treasury yield even ended slightly higher at 3.92%, but not before reaching an intraday low of 3.65%. It is still marking the lowest levels since the second quarter of 2023 in the wake of the Silicon Valley Bank (SVB) failure. The 10Y yield briefly came down to 3.66%, at which point the 2s10s curve was dis-inverted for the first time since 2022 for a short time.

While the inverted yield curve has long been seen as a harbinger of recession, many will say the (quick) curve dis-inversion is actually the more worrying signal. It comes when the Fed starts – or is seen – reacting to either macro weakness or growing financial stresses by lowering rates more aggressively.

Clearly, that is what the market is pricing now in its forward-looking fashion: still close to more than 100bp of easing is priced for this year alone, and even the possibility of inter-meeting cuts is on the table. We would probably see this more as an artefact of markets accounting for lurking financial stability risks following the viciousness of recent market moves across asset classes. That we are back to levels seen during the SVB episode might not be a coincidence. The equity market's "fear gauge" VIX briefly surged to its highest levels since the pandemic. We also observe noticeably wider credit spreads as well but not yet at worrying levels. More generally, risk aversion had already been building up over the past weeks given developments on the geopolitical front.

Fed can wait till September before cutting rates

As for the Fed, inflation pressures have clearly eased over the past months, allowing it to shift its focus to the cooling macro backdrop and weaker jobs market. But Friday's payrolls figure itself is not signalling yet any emergency or recession. This is also corroborated by other data, such as yesterday's ISM services employment component, which actually moved back up into expansionary territory.

The Fed described the jobs market last week still as "strong but not overheated". Yesterday, the Fed's Goolsbee – the FOMC's arch dove – also did not signal any urgency to react to the jobs data. It was but "one number" and the Fed could wait for more data before the September meeting. A similar view was reflected by Daly, emphasising that the FOMC was looking at the totality of the data. She said easing would be needed in the coming quarter, but the when and how will depend on the incoming information

Against the backdrop of the data and such commentary, we see only a very limited prospect of inter-meeting cuts from the Fed. The narrative of the Fed having to ease by 50bp increments could stick. By the FOMC's own indications of the neutral rate – that is looking at the long-run dot plot at 2.8% – there is plenty of room to cut rates just to get to neutral from the current Fed funds target range of 5.25-5.5%.

Markets might have overreacted during a hot summer. We have already seen some indication of dip buying as the 2s10s curve quickly reinverted to -10bp after hitting the flat zero. The viciousness of the recent curve moves is still striking and signals a shifting of sentiment. But looking at absolute levels on SOFR rather than Treasuries we are now still -35bp inverted in 2s10s. In Treasuries the 10Y notes trade at their cheapest (widest) spread versus OIS, muddying the signal, at least in terms of absolute curve levels.

Today's events and market views

The eurozone will publish June retail sales numbers and, at a consensus estimate of 0.1% year-on-year, the expectations are low. Germany's factory orders are predicted to come in at -14.2% YoY, reflecting even lower sentiment about the German economy. The US will release its latest trade balance figures.

In terms of issuance, we have Austria with 10Y and 16Y RAGBs for a total of €1.4bn, Germany with a 5Y Bobl for €4bn, and the UK will auction 19Y Gilts for £2bn. Lastly, the US has scheduled $58bn of 3Y Notes.

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