

Rates Spark: Rates Powder Keg

A few sparks caused an explosive rise in market rates yesterday, but this should not obscure the fact that the bond market has been sitting on a powder keg since last week. Expectations are rightly for higher US rates, and it is logical for long-dated GBP and EUR rates to rise in tandem as appetite for duration ebbs globally. The only nagging issue is the US 5yr still trades rich to the curve; it shouldn't, if rates are really on the up.



Monitoring the 5yr barometer for the next big move

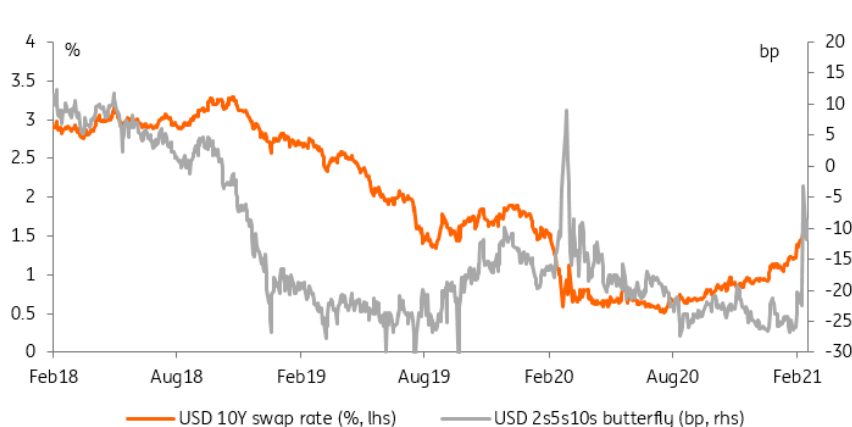
We're not convinced that supply has been the central driver of the rise in bond yields but, as we note below, when the big supply plans come out they clearly have the capacity to be impactful. That can change, but for now reflation is the big driver, at least in the US. The price action yesterday also coincided with the 5yr area underperforming again on the US curve, which remains a key directional impulse.

The anomaly here, in fact, has been the re-richening in the US 5yr in previous days. Remember, even though the 5yr is much cheaper than it was pre last Thursday's US bond market sell-off, it is still in absolute terms rich to the curve (trades through the combination of 2yr and 10yr yields).

If this is a true bear market for bonds, the 5yr would typically be cheap to the curve, and likely getting even cheaper

It is not a bad thing that the 5yr is rich, as it suggests that we don't need to anticipate an explosion in yields. But at the same time, last Thursday showed that the 5yr cheapening and the rise in yields were very much simultaneous.

5yr cheapened on the USD curve last week but has still retraced



That's not how it happened in previous bond sell-offs, as typically a 5yr cheapening process would happen well ahead of the big directional sell-off.

Either way, when we do get to the end of this bear market for USD bonds (likely to see a 2-handle on the 10yr), we will find that the 5yr will have cheapened considerably to the curve, and will end up trading cheap to the curve in absolute terms.

2%

The minimum handle expected for the US 10yr

But being held back for now by a rich 5yr

The sparks and the powder keg

Yesterday's bond market rout can be blamed on a number of factors. We find the most credible one being the higher than expected UK debt management office (DMO) gilt issuance remit. At roughly £50bn higher than consensus, it is no wonder already battered gilt investors decided to reduce their exposure, in particular to the long-end. We should also mention ECB sources relayed by Bloomberg suggesting no action against higher bond yields was necessary at next week's meeting. These in our view were the sparks.

The bond market has been sitting on a powder keg since last week

This should not obscure the fact that the bond market has been sitting on a powder keg since last week. Attitude towards duration among fixed income investors has grown cautious, to put it mildly. The stabilisation of rates markets has been noticeable but we remain convinced that the next big move in rates will be up, [taking 10Y US Treasuries to 2% yield](#) this year. In this context, we do not blame investors for exiting at the first sign of a sell-off.

1% our near term yield expectation for 10Y gilt
after yesterday's budget re-ignited a flight out of bonds

We've highlighted previously that we see no fundamental justification for [reflation fears spreading to the Eurozone](#). The same can be said about the UK, although it faces the prospect of an earlier reopening thanks to a successful vaccination programme. Despite a dimmer outlook, we think this makes the case for [gilt yields testing 1% this or next quarter](#). Subsequent increases should be a lot slower in our view.

A rise in risk premium has been driving the sell-off in US Treasuries

It was noticeable that a rise in risk premium has been driving the sell-off in US Treasuries rather than future policy rate expectations. It is this risk premium that is more closely correlated across currency zones and explains how the US Treasury sell-off is spreading to the UK and Eurozone bond markets. It also explains how highly correlated bond markets can coexist with policy divergence over the medium term between the Fed on the one hand, and the European Central Bank and the Bank of England on the other.

Today's events and market view

All eyes now turn to Fed Chair Jerome Powell's speech late in the European afternoon for signs of a change of tack on the bond market sell-off. So far, only Fed governor Lael Brainard seems to have broken the party line, that a steeper curve is a manifestation of an improving economic outlook. We think Powell will stick to that message, unless of course market developments into his speech give the Fed cause for concern. This could be a long day.

Our base case is for rates to continue rising, and that yields curves will continue steepening, but that the sell-off will remain orderly. Accidents do happen, as last week has shown. This

means we see more upside to rates today than downside.

High duration supply from Spain (5Y/7Y/9Y/10Y/15Y) and France (10Y/20Y/30Y) might complicate matters for EUR rates. There are a couple of ECB speakers on the slate but since the self-imposed pre-meeting quiet period starts now, we doubt they will make comments about monetary policy.

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