Rates Spark: Stability from the Fed as a counter to volatility risks

Part of the Fed's job on Wednesday will be to cause as little consternation as possible. There's been enough volatility to be dealing with. The relative calming of late makes the Fed's job that bit easier this time around. There will be more testing meetings ahead though, where growth versus inflation calls will have to be made. Enjoy this simpler version

US Treasuries are prone to big moves, but tracking along quielty for now

We saw a decent US 10yr auction. It (effectively) came through secondary levels by over a basis point. The indirect bid (external official sector driven) at 71.2% was down from last time but still decent. Direct bidders (domestic real money driven) was up to almost 20%. Overall there was less need for dealers to take up the slack, and the consequential cover at 2.6 times was decent. The reaction saw yields drift down by a few basis points in the aftermath, and that soft tone continued into the US close. Overall, the auction confirms there are buyers of US Treasuries. Flows data last week showed net selling, so at least this is swinging in the other more positive direction.

An important foreign exchange angle continues to bubble away with an undertone for US dollar vulnerability. For example, here has been a spike appreciation in the Taiwanese dollar, on a theory that its first on the list of crosses primed to move on a weak US dollar trade. The Swiss franc experienced something similar some weeks back, and a whole host of other currencies are up versus the US dollar by over 8% year-to-date. That includes the euro, and the Japanese yen. There's an eye too on the likes of the Hong Kong dollar as it sits right on its floor, held there on FX intervention. There's always a risk where lower yielding funding currencies spike, as it exposes liabilities set in them, especially leveraged ones.

At the same time, risk assets of late appear to be in better shape (despite prior scares). But that can change quickly. The coming months will be crucial in this respect, with the clearest risk coming from any material scent of recession ahead. The latter presents a rationale for a downside test to Treasury yields, a more traditional drift lower in anticipation of slower activity (potentially a recession of some description), supported by a rate-cutting narrative from the Federal Reserve.

At the moment though we're betwixt and between, with the 10yr trading around a near neutral valuation at or about 4.3%. Little over the course of this week is set to materially change this.

A difficult start for Germany's government might foreshadow implementation risks

Noticeable volatility around the vote of the next German Chancellor. A failure by Merz to secure the Chancellorship in a first voting round sent equities lower and led to a dip in Bund yields. It was a short-lived move, though, just as the 10y Bund yields tried to break higher out of the subdued trading ranges.

While in outright yields the initial impact of the incoming government's pledge for defence and investment spending has been largely faded, the sensitivity to the political developments shows that markets still put a lot of hope into the spending plans to eventually drag Germany out of a trade war induced rut this year. The lingering concern is that this difficult start foreshadows hurdles around quickly pushing through the necessary investments and reforms. This can mean more volatility on the path towards higher yields that we still project for next year.

The spread of Bund yields over swaps spreads, which should also reflect any supply concerns around the spending plans, is displaying more Bund underperformance. The 10y Bund is now yielding close to 4bp above swaps again. We think this is more a cautious phasing out of recent turmoil as actual supply impact will likely be felt only later this year, if not only 2026.

Wednesday's events and market view

The main event on Wednesday will be the FOMC meeting, but no one expects a change in monetary policies. Ahead of that event we will watch the Treasury Secretary Bessent's testimony to Congress. The main release out of the eurozone is the retail sales numbers for March, which are expected to show a small contraction for that month.

In primary markets France will auction three long-term bonds for a total of up to €12bn while the Italian debt agency carries out a €5bn buy-back operation. The UK auctions £4.5bn in 5y gilts.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com