

## Rates Spark: Supply test ahead

As we hold above 4.5% for the US 10yr, the immediate issue is 10yr and 30yr auctions. Beyond that into next week, prepare for a big drop in US headline inflation. Then again, core inflation and inflation expectations remain sticky. Don't expect a capitulation lower in long-dated yields just yet



### US Treasuries holding in at above 4.5%. Key 10yr and 30yr auctions ahead

The decent 3yr auction was a positive impulse for Treasuries but was not the only underpinning factor. The auction itself saw a decent indirect bid (including the important central bank component), was well covered, and did not tail. All good. A bigger test from the 10yr today, and then the 30yr tomorrow. We should build a moderate concession into these auctions, although the mood music has been to test the downside for yields, a reversal of the dominant mood on Monday which saw yields resolutely rise. We continue the theme of big intra-day movements, and it comes against a backdrop where not huge volumes are going through, manifesting in optics of poor liquidity.

Meanwhile, SEC Chair Gary Gensler has been fretting about leveraged trades in the US Treasury market, noting that it can create instability. At the same time, basis trades and the like are a key component of liquidity in Treasuries. On many measures, US Treasuries are already suffering from a vexed liquidity circumstance. The last thing the market needs is a further curb to liquidity, as that too can pose issues during times of crisis, and/or big shifts in sentiment. This is something we need to keep an eye on, as it can be the precursor to heightened volatility ahead.

Directionally, we continue to regard the 4.5% area of the US 10yr Treasury yield as key. So far we've held above this, and remaining above can set a platform for a resumed re-test higher in yields. The rationale here centres on a continued edge higher in inflation expectations (5yr\*5yr inflation swap now at 2.75%), continued macro resilience, and deficit pressure. Pitted against that is the growing realisation that we'll get a big fall in US headline inflation next week. Not only is there a positive base effect, but the month-on-month (falling energy price impacted) outcome could be so low as to get the headline inflation rate practically down to 3% (or very near to it).

It still leaves the core rate with a 4% handle though so still some work to do. It's that, plus supply pressures that can keep real rates elevated, preventing a collapse lower based on imminent rate cut expectations. That will come, but we need more before jumping to that.

## The latest Fed speakers have given some hawkish pushback

One of the questions after the rebound of Treasuries with 10yr yields rallying towards close to 4.5% was how the Federal Reserve would react having only just begun to point out that higher longer rates could be doing part of its job by tightening financial conditions. Markets had taken this at least in part as a reason to trim expectations of further Fed hikes.

Some speakers such as the Minneapolis Fed's Neel Kashkari have been quite direct in saying that the rate cycle may not be over, and he would still prefer to err on the side of overtightening. Hawkish Governor Michelle Bowman expects further rate increases. While acknowledging the tightening impact of higher long-end rates, she pointed out their recent retracement and volatility, calling for more time to assess their impact. The Dallas Fed's Lorie Logan is also keeping an eye on market yields but stressed the Fed should always stay focused on inflation, which to her looks more like it's trending to 3% and not 2%, and in particular also be sensitive to inflation expectations. This all resonates with the Fed chair's earlier emphasis that changes in financial conditions have to be persistent in order to have policy implications.

Not all Fed speakers have ventured into directly commenting on monetary policy. But even then Fed Governor Christopher Waller still alluded to the overall rise in yields since the summer, meaning even after the rally, the move amounts to a notable tightening of financial conditions. And to be fair, while Treasury yields have been volatile, the adjustment in associated rates such as mortgage rates, which remain at record highs, will be slower.

### Today's events an market view

The data calendar remains relatively light. The focus in EUR rates will be on the retail sales data and a little earlier on the European Central Bank consumer survey's inflation expectations with Isabel Schnabel having pointed out the fragility of expectations as a reason to remain cautious.

It is again the central bank speakers' schedule that is busier, both in Europe and the US. From the ECB, we will hear from Chief Economist Philip Lane, Belgium's Pierre Wunsch and the Bundesbank's Joachim Nagel, among others. In the US, Fed Chair Jerome Powell and the New York Fed's John Williams will deliver speeches at a research conference, but the Fed chair's appearance at the IMF tomorrow will have more policy-related insights.

In government bond supply, Germany will sell €4bn in 10Y Bunds, but the main focus is the US Treasury's sale of a new US\$40bn 10Y note later in the day. A solid 3Y sale last night

helped accelerate the curve's bull flattening.

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