Rates Spark: The 4.5% line in the sand is breached

The US 10yr auction tailed, but the bond bulls don't seem to care. It looks like the market is playing with a change in the rate cycle discount. It's not illogical, but likely a tad early, and ignores the higher deficit-induced real rate narrative. That has not gone away, but it's under wraps for now

US Treasuries want to keep testing lower in yield for now

The US 10yr auction tailed yesterday (by 0.8bp), which is typically not a great look. But the market was firm through the auction, which tends to increase tail risk. Not a big deal in the end though, as other auction statistics were strong. The near 70% indirect bid was strong (again) and the cover was good (as is typical). Most important the 10yr is holding on to an ambition to break lower, having managed to dip below 4.5% again (it got briefly below post payrolls).

The 30yr is up for auction tomorrow. There is a decent tone built ahead of it. There is no evidence of a material sell objection to the move lower in longer dated rates. Given the break below 4.5% for the 10yr we need to consider more deeply the notion that this market is moving away from higher real yield concerns, and moving more towards the more structural theme of (probable) lower official rates in 2024. We've removed our tactical bearish stance based off this.

This market clearly wants a bit more follow through in the guise of lower yields. Assuming we get through the 30yr auction in decent shape, the next big impulse comes from next week's US CPI report, which should be market supportive. At least the headline inflation will be closer to 3% than 4%, although core inflation is expected to remain slightly above 4%.

The latter still argues that we should not be getting too carried away with the falling market rates narrative, especially for longer rates. Lower shorter rates are a better bet, especially based off a Fed that has likely peaked. For now, while we accept that 4.5% has been breached to the downside, we maintain a degree of discomfort from any material lurch lower from here in long dated rates.

Not saying it can't happen. But if it did, it completely undoes the prior discount for a deficit-induced elevation in real rates. That can't have gone away completely. It can of course be dominated by a change in the rate cycle. But we're not at that point just yet. Still, should the US 10yr hold below 4.5%, it then increasingly smells like the build of a change in the rates cycle discount.

What does that look like? That starts on the back end through creeping lower rates, and eventually morphs to the front end, which catapults lower 3mths ahead of a first cut (and so too early for the second bit just yet).

ECB speakers push back against early rate cut pricing, and add a twist to the curve

The reflattening of curves remains the theme of rates markets. But it also comes with a twist as central bankers push against what they seem to think is a premature easing of financial conditions with their inflation fighting job not yet done. Indeed, 2Y yields both in the US and EUR are holding up and can even book small increases while longer rates continue to fall.

We had earlier highlighted the Fed speakers, and yesterday was busier on the side of the European Central Bank. The tenor was that the last mile of fighting inflation is going to be the hardest. While acknowledging that the likelihood of further hikes has decreased, they are not completely off the table. Talking about rate cuts at this stage was counterproductive.

As if to underscore the point that inflation risks are still tilted to the upside the ECB consumer survey showed 1Y inflation expectations rising to 4%, their highest since April. The 3y inflation expectations remained at 2.5% but have basically plateaued around 2.3-2.5% since April. The caveat is that the shorter dated expectations largely move along with energy prices, and the survey will not have covered Brent prices dropping below US$80/bbl these days. Alongside weaker macro data of late, this drop to a good part likely helped the 5y5y inflation forward fall toward 2.4%.

On the face of it that should be a welcome development amid the inflation fight, but given the sensitivity to factors such as energy amid a still highly uncertain environment it does not contradict the concerns expressed by Executive Board member Isabel Schnabel that inflation expectations remain fragile.

Today's events and market view

For now we do not expect any let-up in officials' push back against the notion of earlier rate cuts. Fed speakers will return to the spotlight with the main act being Fed Chair

Powell's participation in a panel at the IMF on monetary policy challenges.

Today's jobless claims data is one of the few data releases this week that could prove more market moving. Initial claims remain low, indicating firms are not feeling pressure to fire people, but with continuing jobless claims now up 160k in the past month and a half, it appears that if you do lose your job it is becoming more difficult to find a new one.

With the US$24bn 30Y UST auction a key supply event looms later tonight, but supply concerns seem to have become secondary for now.

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