Rates Spark: The drama is in the plumbing

Treasuries are treading water, and really should have performed better on a risk-off Tuesday. But the 10yr seems content at above 4% for now. The 2yr has more open road to trek back down to 3.5%. Wednesday’s refunding announcement should be a box-ticking exercise. The plumbing of the money markets is where all the drama is - keep an eye on it

US money market liquidity conditions have calmed, but continue to bubble

From a US perspective, there are two key items to monitor ahead. The first is the refunding announcement due on Wednesday. It should be uneventful, likely a copy and repeat of the previous quarter's rhythm in terms of size and distribution. If so, it would continue Treasury Secretary Bessent's policy of minimising disruption in longer-dated yields. These are linked to the key 30yr mortgage rate, and there is an ambition to get that down if possible.

The most likely outcome is no surprise on the issuance plans. At the same time, the market knows that this particular Treasury is quite capable of shrinking long-dated issuance if it really needed to (adding to the weight being taken by bills). Again, no dramatics are expected -- especially as the 10yr yield is not at a particularly elevated level. However, the refunding event still needs to be monitored.

The second item requiring watching is the plumbing of the money markets. It's still nowhere near the extremes of September 2019. However, at the same time, elevated repo levels have been an ongoing feature over the past few weeks. It’s a reflection of ongoing quantitative tightening (which continues), albeit mild in recent months. More pertinent has been the heavy issuance of net bills and build-up in the Treasury's cash balance, which, by definition, takes cash from bank reserves. The absolute level of reserves is still relatively comfortable when compared with September 2019 when it got too low (see more here).

But both the effective funds rate and repo have been under rising pressure, indicating that some players are willing to pay up for liquidity. Meanwhile, the Federal Reserve is broadly balanced, taking in as much on its reverse repo facility and offering out to the market in repo. Given that, the tightness shouldn’t persist for long. If it did, the Fed could accelerate its plans to buy bills (already set to start this process from 1 December). There may even be a case of liquidity hoarding now that it has become a recognised phenomenon. Either way, there is a ready solution: the Fed rebuilding reserves through bill buying. (Or, even better, the Supplementary Liquidity Ratio adjustment is brought forward pronto; see more here)

Wednesday's events and market view

After a dearth of data, Wednesday could deliver important directional cues for the bond market. In the US, all eyes are on the ADP payroll data, given the lack of official releases. The median expectation is for a 40k increase in jobs after a 32k contraction last month. The ISM services is the other highlight, where consensus is looking for a slight improvement to 50.7 from 50. There will also be a busy slate of Fed speakers, including John Williams, Michael Barr, Christopher Waller, Beth Hammack, Anna Paulson and Alberto Musalem.

The Eurozone features the PPI for September as well as the final Eurozone PMIs for October, alongside the services PMIs for Italy and Spain. Scheduled European Central Bank speakers for the day are François Villeroy, Joachim Nagel and Martin Kocher.

In terms of issuance, Germany will reopen 15y and 20y bonds for a total of €2bn. Italy is in the market with buyback operations of short-dated paper to the tune of €5bn. The US will make its quarterly funding announcement, providing the sizes for the upcoming coupon auctions.

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