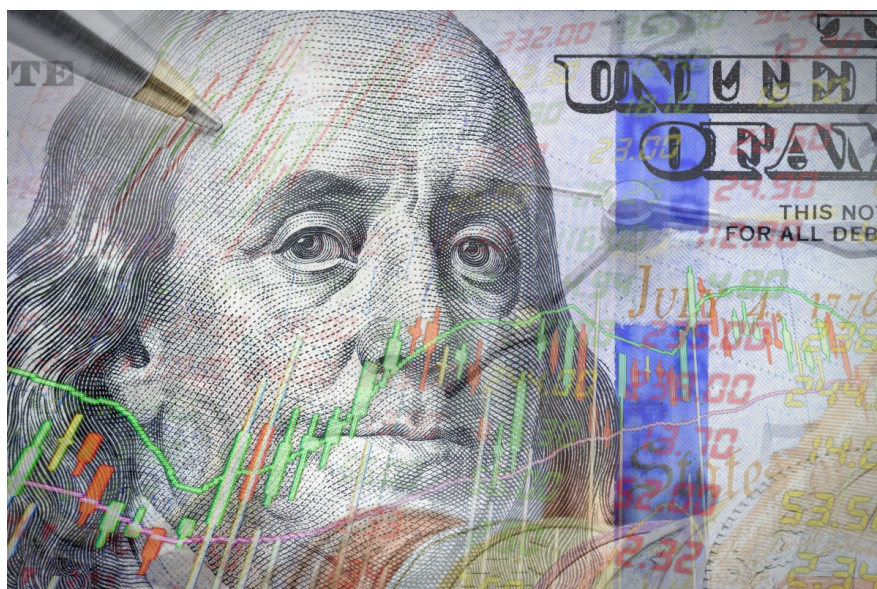


Rates Spark: The glass half empty trade

The drivers of Doge, Bessent and SLR have been added to in the guise of weaker consumer confidence and a ratchet down in expectations for the terminal rate. This market is now considering the possible downsides ahead. Can it last? Well yes for a bit. But we are constrained to the downside for yields, until or unless we seriously contemplate a recession of sorts



US Treasuries find a way to see the glass half empty version of the Trump cocktail

We point again to some of the impulses out there that have been driving Treasury yields lower.

First, the Department of Government Efficiency; the doge-tracker.com site has logged US\$55bn of “tax dollars saved” so far, 2.75% of the US\$2tn goal. It remains unclear how realistic the doge spending cut goal is. But still, it can’t be ignored as something that could help contain the fiscal deficit, and by extension Treasury issuance requirements. And in the extreme, it can hurt GDP, especially if even halfway to the target is realised.

Second, while Treasury Secretary Bessent cannot control the 10yr yield per se, it’s clear that he has an overt ambition to get it lower. Third, potential adjustments to the supplementary liquidity

ratio, in particular with reference to exclusion of Treasuries in the measure. This would free up balance sheets at banks, ultimately adding to liquidity in US Treasuries. And that in turn helps Treasury yields to trade lower than they would otherwise.

We believe that these three factors have already been somewhat impactful already, as we see on the spread from 10yr SOFR to the 10yr Treasury yield, which has tightened from 55bp to 40bp since the turn of the year. The US 10yr Treasury yield at around 4.5% was flat to our estimate of neutrality. It has since broken down to 4.3%, in the past 24 hours driven by a dip in consumer confidence, and a ratcheting down in the terminal Fed funds rate.

When the 10yr hit 4.8% in mid-January, the market distilled a net upward risk coming from the Trumpian mix of policies. The reversion back below 4.5% to now 4.3% represents the distillation of a different outcome, one where the mix of policies are net negative. It's tough to resist this move for now. The implied floor from the funds strip has shifted down to 3.5%, mostly on a whim. But that's all that's needed to make some room for the 10yr yield.

The tactical bullish impulse that we identified some weeks back has turned into something more sinister. Still tactically bullish, or at least neutral given the size of the move. Expect the unexpected though, as this market can just as easily decide that the glass is half full again, and that's when the structural view of the 10yr getting to 5% can be latched on to. Clearly not the mood music right now though.

The half full glass of the US didn't spill over much to the eurozone

Spillovers from the US risk-off sentiment to euro rates were channelled mainly through the back end of the curve with the 30-year swap rate some 6bp lower. Risk assets showed little directionality, suggesting markets were predominantly focused on US domestic concerns. Also the front end of the swap curve remained relatively anchored, continuing to trade consistent with a European Central Bank landing zone in the range of 1.75-2.00%. The 10Y Bund underperformed swaps by a basis point, which shows that recent German developments trumped any safe-haven flows from risk-off sentiment.

Market moves like those on Tuesday highlight the growing independence of euro rates versus the US. The correlation on the short end of the curve has already completely broken down since the US elections, whilst for 10Y tenors the spillovers also lessened significantly. If we look at implied volatility metrics we see a strong divergence with euro rates volatility still gradually coming down whilst US volatility has been trading sideways since much of 2024. And again, US volatility jumped up on Tuesday's move but euro volatility did relatively little.

The ECB's Schnabel keeps throwing in hawkish arguments

Meanwhile, the ECB's Schnabel is turning increasingly hawkish and during a speech at the Bank of England gave arguments for why short rates could stay higher compared to pre-Covid. The reasons cited include persistently large fiscal deficits and quantitative tightening and she underlined that deglobalisation can structurally increase inflationary pressures. We too think markets are pricing in too little structural inflation risks, looking at 5y5y forward inflation swaps which trade at just 2.1%. At just 10bp above the inflation target this reflects a minimal risk premium when compared to the period before the Global Financial Crisis.

Wednesday's events and market views

A relatively light Wednesday in terms of data, with US home sales and building permits likely the highlights. From the Bank of England we have Dhingra speaking on the interaction between trade and monetary policy, which is very topical.

Germany will auction 11Y and 13Y Bunds for a total of €2bn. From the US we have 2Y FRNs (\$28bn) and a new 7Y Note (\$44bn).

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