

Rates Spark: The pressure cooker eases

Market rates have drifted off their highs. It mostly reflects an easing in inflation expectations. But its also been helped by the severe risk-off seen in previous weeks which has pushed the bond market on to the ropes. The thing is, if we move to risk-on, that would provide room for real yields to resume their uptick, ultimately pressuring yields up again too



Risk-off has morphed to some risk-on, correlating with a decompression of the dollar premium

A key undercurrent of price action in the past few weeks has been the bursting of the dollar bubble, or at least a denting of it. We see this not just in the FX crosses and the dollar trade weighted index, but also in the key cross currency swap basis, where for example the EUR discount has tightened from in excess of -30bp to -26bp and it continues to edge lower. The dollar premium is shrinking.

The dollar premium is shrinking

This is helping to take some stress away from emerging markets. And the stall in the rise in real rates has helped the higher beta space generally. We also see an element of this in a tightening of

the Treasury – Bund spread, which had topped out at over 200bp, and is now in the 170bp area.

The fall in US Treasury yields in the meantime has correlated with falls in inflation expectations, which had been above 3% in the 10yr, and are now in the 2.6% area. All in all, a pronounced decompression of stress.

Have we seen the turning point in rates? Maybe; but unlikely

Given that, have we seen the turning point in rates? Maybe; there's enough there to make the beginnings of a case. But still unlikely. The 5yr is still too cheap to the curve, the 2/5yr is showing resistance to flattening, and the rise in real rates is not necessarily over.

This risk-on phase has a way to run yet, but it still smells like many of the above new trends can easily prove to be short-term ones, and we revert to a re-test higher in market rates.

The US front end remains bubbly though, in part reflecting super strong tax revenues on a firm economy

On the US front end, the cash going back to the Federal Reserve in the past week has been heavily impacted by Government Sponsored Enterprises (GSE) cash that has been parked on repo. That came to an end yesterday as that cash gets taken out of repo. It should allow for an easing in volumes going back to the Fed. But it still remains very elevated.

Market repo continues to struggle

Market repo continues to struggle to match the 80bp on offer at the Fed's reverse repo window. The latest SOFR reading at 78bp is in fact an underestimate of the downside risks seen in the past week. Not only has chunks of GSE cash been a factor on repo, but less T-bill issuance has been a feature too. The US Treasury is chock-a-block full of tax revenues as the contemporaneous economy continues to boom.

The US Treasury is chock-a-block full of tax revenue

There may be credible talk of recession and slowdown in the air, but the front and centre economy remains hot. Hence the reduced need for the US Treasury to come in and issue bills, which typically can help to redress the imbalance between excess liquidity and collateral, helping to push repo rate higher.

Balance sheet roll-off ahead will help, but realistically is may not be till 2023 before there is a material impact from this.

A flurry of US data to watch ahead of a long US weekend

Yesterday's US 7yr auction was stellar. Phenomenal actually. There was a huge indirect bid, indicative of foreign (including central bank) interest. A massive cover too. It helped to place something of a cap on the effort being made for yields to be tempted higher. Overall, this is indicative of an improved demand for fixed income. This always looks more impressive when the market is risk-on. It shows there are certainly buyers out there.

With the key supply behind us, today sees a focus on the the US core PCE deflator. It has been one of the favourites of the Fed. It is currently running at 5.2% year-on-year, and the market is looking for an easing to 4.9% YoY. A sub-5% number would gel with the notion that inflation has peaked, and should help underpin the easing seen in inflation expectations in recent weeks.

We'll also see US personal income and spending, but there should be more interest in the forward-looking University of Michigan indices for May. The market discount is for these to be stable, but the risk is for a surprise to the downside.

The eurozone awaits a smattering of regional consumer confidence readings for May and retail sales reading for April. They are in fact quite important given the slowdown seen in eurozone data of late, but as is typical tend not to have a big market impact, barring an exceptional outcome.

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