Rates Spark: US Treasuries primed to react

We think Treasuries have settled back to a more typical role, as the traditional comfort blanket should risk assets sell off, or on any negative news for the economy. Should Friday's payrolls come in as expected, little reaction is likely though. The biggest reaction would come from a materially weak number. But it just might a tad early to get that

The long end of US yields will continue to feel upward pressure from fiscal concerns

US Treasuries are settling back to more normal behaviour – inversely related to the economy and equities

It's been quite the journey for US Treasuries since 'Liberation Day'. That journey included a period that had a dangerous feel to it as US Treasuries were not behaving as they should as risk assets sold off. There was a de-rating of Treasuries theme in play, and the flows showed a clear net selling of duration.

That theme has waned in the past week or so. Instead there has been a tendency for Treasuries to behave more in tune with the build of a discount for a recession risk. The macro expectations data support that discount. However, the solid performance of risk assets argues against a fear for recession.

The price action through Thursday is a case in point, where a clear risk-on theme on the day coincided with some upward pressure on Treasury yields. Some of the equity market reaction is a tad perverse, being based off an expectation for interest rate cuts from the Federal Reserve. But at the same time it has to be said that earnings have not shown a material weakening.

That said, there is plenty of anecdote and example of growing weakness in the economy that equity markets are for now choosing to ignore. From here it's probable that the macro data, if bad enough, is likely to begin to dominate market reaction. Equity markets will likely begin to realise that the Federal Reserve is nowhere near delivery of an actual rate cut, even if the macro numbers are weak.

The issue for the Fed is there is still considerable fog out there with respect to the implication of tariffs on prices and inflation in the US. It will be a number months before that fog potentially begins to lift, and in the meantime the Fed will likely prefer not to react in too swift a fashion. It would be different had there not been an inflation risk (that cannot be ignored).

Payrolls are up next, and will be a tad weak, but likely not weak enough to spark consternation

Friday's payroll report will not pick up a material reaction from the tariff story. There will be some, as the collection week is the week of 7 April. But realistically, it will be the May report and beyond before we get the beginnings of a material reaction. And in fact, it might not be till the late summer before the data risks really falling away.

As it is, there an market expectation for 130-140k of employment generation. That's only marginally below the 150k that is regarded as the replacement rate (basically a neutral number). While we ourselves believe it can be lower than this, it's unlikely to be bad enough to garner material reaction. The unemployment rate, too, is set to hold in the 4.2% area.

> Get that, and Treasuries will ignore and move on. But this market is most vulnerable to a weak number, in the sense that it would garner the biggest reaction (lower in yield).
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> In months to come we can see a time when Treasury yields could come under upward pressure, most likely on passage of a big tax cutting package, on a theory that there is no plan for the fiscal deficit. But that's for later. For now, expect Treasuries to react in a more traditional manner. So any material weakness in the payrolls number should force yields back down. Expect a lessor reaction should the number come out stronger than expected. Yields up, but not dramatically.
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> As always though, the market reaction to payrolls is often the most perverse of all. It often does the opposite of what it 'should'. And when it does, interpreting that can provide a good steer on the underlying mood for Treasuries on a multi-week basis.

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