Rates Spark: Volatility has calmed, but there's lots going on

US Treasuries are bracing for another potential government shutdown. And there is an eye on FX intervention. Overall, rates volatility is coming down again and front-end euro rates, in particular, show little movement, which is conducive to carry trades. This is good for risk assets but can amplify market shocks if central bank policy surprises

The yen's sudden strength reflects dollar pressure

US Treasuries are dealing with so much that the path evolving is an unchanged one

Quite a few moving parts to take into consideration.

First, the US dollar is under some pressure. On the other side of that trade are two key elements, the dramatic rally in gold and the snap stronger in the Japanese yen. The latter is manufactured through an intervention threat. But it is also a reflection of prior extreme weakening in the Japanese yen, driven by a policy mix of ultra-low rates for too long, mixed with the inconvenient truth of a mammoth debt/GDP ratio, whose prognosis is too uncomfortable to contemplate. The rally in the price of gold squares the circle, which is, in the end, simply a supply-versus-demand determination. Simple, and offering an alternative to messy alternatives, for e.g. central bank FX reserves.

The implications for treasuries are complicated. At the margin, it likely means more rate cuts and more inflation, and hence a steeper curve from both ends (as a stand-alone impulse).

The Fed meets this week with a green light to not do much at all. While at the same time, DC is shaping up for another government shutdown in the wake of objections from the left following recent events in Minnesota (related to heavy-handed treatment of ICE protestors). That could mean another dearth of government data down the line, making for difficult interpretation of the economy. At the margin, this would place some downward pressure on yields, but not in any dramatic sense.

At the same time, yields have calmed and are not showing huge direction. Lots going on, but we're holding at 4.2% on the 10yr, and feeling quite stable here. But at the same time, vulnerable to getting pushed around. There is clearly demand on the front end though, with the 2yr auction results showing stellar results. The fact that the Fed is buying bonds out to 3yrs is not dispositive, but it is a help.

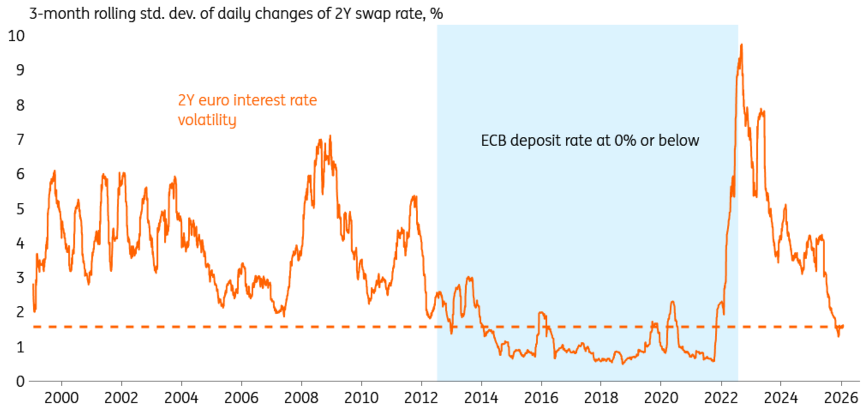
Low rates volatility makes a supportive environment for carry trades

With rates volatility coming down again, the supportive environment for carry trades seems to be holding. Not a day goes by without the European Central Bank (ECB) reiterating that it is in a “good place”. And indeed, if we look at the volatility of the 2Y swap rate, we can agree that the ECB managed to pull off a soft landing. The risk still seems tilted towards more cuts, but even after last week’s market turmoil, the probability of a cut before June never exceeded 20%. Unless we have a series of lower growth or inflation numbers, we find it hard to see a scenario where markets start moving the front end materially.

The carry positive environment is also reflected in the tight spreads on European Government Bonds (EGBs). The spread between 10Y Italian and German government bonds is hitting new lows and French budget wins quickly translate to tighter spreads too. Our structural view still sees EGB spreads settle wider, but in the near term we also find it difficult to identify catalysts that would trigger a repricing.

Having said that, a period of low rates volatility and the consequent build-up of carry trades can also amplify market shocks in the future. For example, in August 2024, we witnessed a significant risk-off event when the Bank of Japan unexpectedly tightened monetary policy, triggering a global shock to equity markets. Whilst not our baseline, any hawkish surprises from the Fed or ECB monetary policy will be felt by markets.

Rates volatility was only lower when the ECB was at the zero lower bound



Source: ING, Macrobond

Tuesday's events and market views

Not a lot of notable data from Europe. From the US, we have the Conference Board consumer confidence, which consensus sees ticking up from 89.1 to 90.9. Looking at recent history, though, the trend seems to be down. Other US data includes the Richmond manufacturing index and ADP weekly employment figures.

In terms of supply, we have Germany start with a 20Y syndication for an estimated €5bn. From Italy, we have a 2Y BTP auction, combined with 6Y and 30Y BTPei auctions, together totalling €5bn. Later, Germany will also auction 2Y Schatz for €6bn. Lastly, from the US, we have a 5Y Note auction for $70bn.

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