

Rates Spark: Yields have spiked, but levels are far from overly elevated

The 'back and forth' on Greenland *is* an issue. But nothing has actually happened. The same goes for the Trump pick for the Fed chair. It's all talk. The rise in Japanese bond yields, however, *is* a thing. It reminds us that inflation and debt dynamics *are* issues for bond markets, ones the US Treasury market should not ignore. We likely calm now, but this is not over



Monday's sell off of Japanese government bonds, led to yields rising on US Treasuries on Tuesday

Rationalising the rise in Treasury yields is more simple than geo-politics

The rise in Treasury yields since Friday reflects a combination of factors. Talk on Friday that President Trump might hold on to Kevin Hasset is *not* one of them. It was a spark for sure, but not the driver. Remember, Kevin Hasset has not been the front-runner for a number of weeks now, as he was overtaken by the other Kevin (Warsh). Also, the market had never discounted a super-dovish Fed in the first place. And for good reason, as the mathematics never added up that way. So, bond yields spiking on the Hasset story never made complete sense, apart from it being a spark that lit up a path of least resistance for higher yields (for many other reasons).

Then we turn to Tuesday's movements. Now the thing is, global markets were open on Monday, and there was no particular new news on the Greenland 'back and forth' between the US and Europe by Tuesday. All was known on Monday. Even Japanese yields rose dramatically on Monday, but global yields did not react, at least not like they reacted on Tuesday. The only difference between Monday and Tuesday is the US was closed on the Monday. And yes, in the background, Japanese yields had spiked again, except this time, prompting some associated US dollar weakness, and then, higher US yields.

It's not that the Hasset story and the Greenland threats are not relevant. They are, it's just that nothing has actually happened in this space, apart from words being spoken, followed by lots of supposition. But there is other background noise that is proving far more relevant. First is the reality of elevated inflation and elevated deficits as an issue that has not garnered the fear that it should have, especially in the US. The moves in Japanese Government Bonds (JGBs) act to remind Treasuries that they too have issues on both of these fronts.

The 30yr JGB yield is now just short of 4%, and the 30yr US Treasury yield is just short of 5%. And why not? After all, Japanese inflation is at 3%, and US inflation technically rounds up to 3%. On the fiscal side, it's the rising interest rate costs that concern Japan the most, on an already eye-watering high debt/GDP ratio. While in the US it is more about the absolute size of the fiscal deficit. The delta has swung on the deficit, which is good, and has allowed swap spreads to narrow. But underlying fiscal problems remain.

Japan is the trigger now for the eurozone, but fiscal concerns are a global thing

The back end of the euro curve is being driven by global spillovers, but the front end remains remarkably stable. Bund yields shot up alongside the sell-off in JGBs but over the course of the day the impact was a mere 2bp for the 10Y. Markets now price in a 25% probability of another European Central Bank rate cut this year, only mildly higher than earlier this month. These market moves suggest the eurozone's macro picture has not really changed much and that most of the moves can be attributed to the JGB volatility.

As government spending concerns keep playing across the world, the path of least resistance is still for steeper curves. Japan is not the only country facing fiscal challenges and as global rates rise, budget deficits will only be strained further. This environment makes it difficult to find safe havens in government bonds and therefore gold being the big winner this week should not be a surprise. Our FX strategists also pointed out that currencies, especially from countries with healthy government finances – specifically NOK, SEK and CHF – did well during this bond sell-off.

Wednesday's events and market view

Amid geopolitical tensions, all eyes will be on Davos, where Trump is expected to speak at 14:30 CET. Data will be secondary, also given the very few releases of note after the UK CPI in the European morning. The US will release MBA mortgage application numbers and pending home sales. There won't be any relevant releases out of the eurozone but the ECB's Lagarde, Villeroy and Nagel will speak at Davos.

Primary markets remain busy with syndicated deals from Austria (new 10y benchmark and green bond tap), Finland (new 15y) and Cyprus (new 10y) alongside scheduled auction

supply from Germany in 15y and 30y bonds (€2bn). The UK will auction 3y gilts.

The main focus will likely fall onto the 20y UST auction (US\$13bn) as markets revert to looking for any evidence of a 'Sell America' narrative.

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