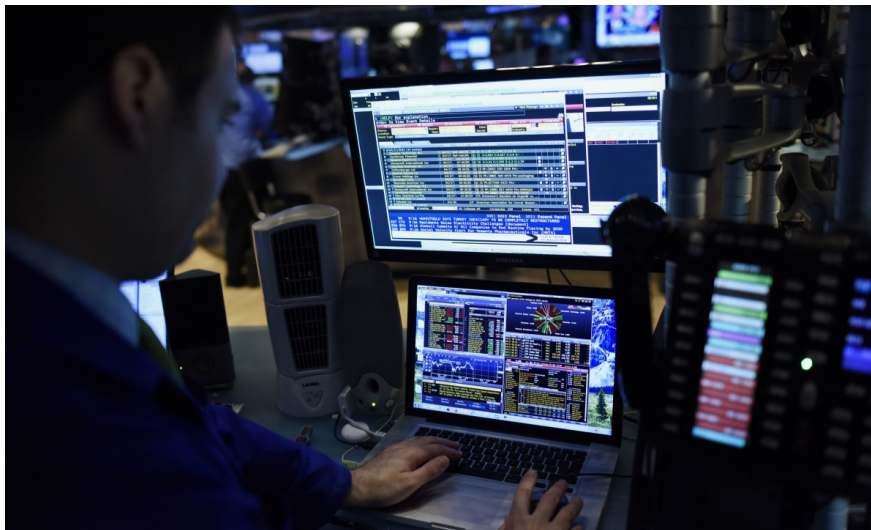


Rates: Still biased to rise

We're off recent highs for 10yr rates, but we think that the current momentum points to hitting those highs again, then likely breaking above. The Fed and the ECB may be done, but market rates are not. We risk reverting higher until or unless we see material labour market weakness, especially in the US



There are many good reasons to expect the upward pressure on market rates to be sustained.

Key levels have been hit, and there's more to come

In the past month, the US 10-year yield has touched 5%, and 10-year Euribor hit 3.5%, with the Bund practically hitting 3%. All key levels, and a clear manifestation of a prior pivot from the unnaturally low rates seen during the pandemic years. Even the 10-year Japanese Government Bond (JGB) is now belatedly journeying toward 1%, a level not seen in a decade. There are many good reasons to expect the upward pressure on market rates to be sustained, at least until we see a material change in the complex macro mix that continues to feature a tint of residual strength – or at a minimum, resilience. Inflation is down but not out, meaning the battle continues.

The Bank of Japan had been a hold-out for a long time, but the manifestation of this in yen weakness has been there for all to see for a prolonged period. The European Central Bank (ECB) was also relatively slow to kickstart hikes. Even the Federal Reserve was late to the rate hike process as inflation was allowed to take hold first. The ECB and the Fed are likely done at this point, but the bond market is not yet calling a halt to upward pressure on longer-dated rates. There are lots of reasons to worry, but also lots of reasons to expect a continuation formation where market

yields remain elevated with ambitions to re-test higher. We are likely at or close to highs, but can also still march higher first.

In the past couple of days, there has been a material move lower in market yields, with the US 10yr down to 4.65% and the 10yr German bund yield down to 2.7%. This is below recent highs of 5% and almost 3% respectively. The key driver has been evidence of stress in expectation measures. There has also been continued success in getting inflation lower. On top of that, the US Treasury issued issuance plans that took some pressure off longer-dated maturities. We aren't convinced that this is the end of rises in long-dated market rates, though. For that to happen, we'd need to see material labour market weakness – especially in the US.

Higher real rates as a function of deficit and labour market pressure, with the BoJ only getting started

Moving forward, we identify several factors that can pressure longer-dated yields even higher. First, there is the concern that JGBs finally have lift-off. While we are not convinced this is necessarily catastrophic for US Treasuries, it does, at the margin, pressure the spread to Treasuries tighter. Any hint of structural US dollar weakness would limit the protection in higher Treasury yields further from the point of view of the international investor. This can often become a self-fulfilling prophecy, where the marginal investor runs scared of the story, bringing higher yields with it.

Second, while Treasury Secretary Janet Yellen has suggested that higher real yields do not reflect the higher US deficit, it's tough to agree with this assertion. Higher deficits most definitely correlate with higher real yields, and the US is now staring down the barrel of a \$2 trillion refunding requirement. All other things being equal, such heavy supply pressure correlates with a steeper curve, primarily driven by higher real yields. The US 10-year real yield is now approaching 2.5%. It does not need to ratchet a whole lot higher, but there is also no immediate impulse for it to pull lower.

Third is the conundrum that is tight labour markets. We see this in the US front and centre. But even in the eurozone, there is no material generalised labour market angst. There is even an element of this apparent within many emerging markets and in other developed markets, like Australia. Something in the works is keeping the labour market ship afloat despite the tightening pressures coming from central banks. This won't last forever, as the pressure at a certain point will become too much. But for now, it remains a source of pressure for the maintenance of high market rates.

The latter point is important as there will be a tipping point ahead, but we are not at it now. For that reason, the highs hit in the past month for Treasury yields, Euribor rates and Bund yields are still liable to be seen again. That means above 5% for the US 10-year Treasury yield, and 3% for the German 10yr bund yield remain targets during bouts of bond market weakness.

We're on the eve of a pivotal payroll report too, which will have a material effect, either validating the recent fall in market rates, or causing a re-consideration of the better mood on bond markets this week; where a decent report puts renewed upward pressure on yields. For choice we're expecting the latter.

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