How high will bond yields go?

How high will bond yields go? That depends on how soon and what sort of trade deal we are getting, if any.

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Up, up and away!

Since their September intraday low of 1.4271%, 10Y US Treasury yields have moved erratically higher. But the recent move taking them to 1.94% sets a new high since that low. You have to wonder, how much more? The answer is relevant for us, since the fate of Asian currencies such as the KRW and CNY will rest on similar considerations. The next retracement level of note for yields from charts looks to be 2.12%, so a further 20bp or so increase in yields looks to be eminently plausible in short order. But is this also consistent with fundamentals?

Model-based approaches are one way of looking at this question, but then I don't think fundamentals were what took bond yields to their recent lows, so asking how high they might go "fundamentally", ignores what happens if the same factors return again. I refer of course to trade war fears.

And the news here remains messy, but perhaps in a different way than before. I checked my phone as usual this morning on the way into work for any tweets or clues as to which way this was going. But aside from one tweet from the US President, saying that talks were coming along "very nicely" but adding that China wanted a deal much more badly than he did, there wasn't much.

This tweet doesn't, in fact, tell us anything new. I think it is virtually a verbatim repeat of one from several months back, when bond yields were heading in the opposite direction.

So if there is nothing new here, are markets simply now talking themselves out of recession fears in the same way that they talked themselves into them previously?

The outcome is looking increasingly binary

I confess that some sort of trade deal does look in the works, but the other news from the twittersphere is less comforting. The problem is that it is not at all clear who, on the US side is in charge of the negotiations. Robert Lighthizer is officially the lead negotiator. But ultimately, it seems as if the President alone can decide whether a deal will happen. His adviser, Peter Navarro, is taking a characteristically tough line, and as his comments reported on line suggest (he doesn't appear to tweet himself), talk of rollback of tariffs may simply be fake news. Still, even he seems to view some sort of "glide path to a phase one" deal as being a realistic assessment of the current state of play. If so, then how does this relate to the bond market and Asian currencies?

From our perspective, some rollback of tariffs would need to be delivered in order for China to sign up to any deal. Let's not forget that China also has needs and demands from this deal, it is not all about what the US wants. So if no rollback, it is hard to see even a phase one deal happening. And if not, and no deal ensures, then a rapid plunge to new bond yield lows would likely be on the cards.

But that then also suggests that any deal that ***does*** get done, ***will*** involve rollback, and ***will*** involve some concessions on Intellectual Property (a US red-line), and so could be regarded as somewhat substantive.

That could be enough to see bond yields pushing up against that 2.12% resistance. and maybe even through it.

What it does ***not*** look like we will now get, which was once a third option, was a deal which basically just acknowledged the Chinese efforts on increased agricultural purchases, and made some half-hearted commitments to looking again at tariffs based on some future contingencies. That sort of "Dino" deal (deal-in-name-only) would have been unlikely to support bond yields at today's levels, and so would likely have given way to a slide back down, though perhaps not as rapidly as with a clear no-deal outcome, complete with recriminations and escalation.

At least this helps clear the options a little. Our probability tree now looks to have one less node on it.

Asia Day ahead

We have already had core machine orders for September from Japan today. That data is a proxy for current business investment in plant and machinery, so it helps form opinions about the strength of overall economic growth. 3Q19 Japanese GDP is due out on Thursday, so this is one of the last bits of hard data before that figure will be released. And it wasn't good. Despite rising 5.1%YoY, up from -14.5% in August, September orders fell 2.9%MoM. This is hardly the front-loading ahead of the October consumption tax hike that saw orders in March 2014 rising 13.7%MoM (admittedly falling sharply thereafter). So it now looks as if we are relying on what looks like it will have been about a 2.8% real consumer spending boost to deliver a stronger outcome than the 0.9%QoQ (seasonally adjusted annualised rate) forecast.

(And From Prakash Sakpal): Bank Negara Malaysia's (BNM) move on Friday to ease via a 50 basis point reserve requirement cut comes amid deteriorating economic conditions. And we expect BNM to go further with overnight policy rate cuts. This week's data on September industrial production (due out today) and 3Q19 GDP (due on Friday) should underpin rising downside growth risks. We have recently revised our 3Q GDP forecast to 4.4% from 4.8%, taking down the full-year 2019 forecast to 4.5% from 4.7%, and expect at least 50bp BNM policy rate cuts in the first quarter of 2020.

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