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RATES SPARK

Rates Spark: What the... is going on?

Lots of supposition out there on the drivers of higher long-end yields. A chunk of it is simply a move to a tad above normal. Higher US real rates is the engine. Getting to normal rates is a minimum ask (hope the BoJ is attentive). Eurozone rates suffer to boot on added energy and climate-related inflation concerns, as well as resuming issuance concessions

Even with the rise in real yields, we are only a little above what we consider 'normal' rates

It's all about US real yields, for the long end in particular

We could tell a long story with numerous angles, but there is one theme that cuts through the lot – the elevation in US real yields. That's what's going on. In the past six months, practically 100% of the rise in US 10yr nominal yield has come from a rise in the real yield.

Drivers? Is AI-induced long-duration issuance pressure the latest narrative? In part, yes, agreed. It's up 10-fold relative to only a couple of years back. But we're not sold that this is *the* explainer. Heavy corporate issuance is typically not a problem if there is strong demand, and there is strong demand. Credit spreads remain contained to boot. It's only a part of the narrative, and nowhere near the largest part.

There is absolutely the issue of higher issuance generally, globally, reflecting higher fiscal deficits right across developed markets. We'd argue that this is a bigger issue than the aforementioned AI issuance spree. Fiscal deficits are not contained, and the longer they remain un-anchored, the more persistent is the anticipation for more issuance into the medium term. It's an issue that has been with us for years now, and so not new. But absolutely relevant, as it's persistent and not going away any time soon.

But we should not forget that a lot of the move is real yields simply getting back to more 'normal' levels. Before the Iran war, the 10yr real yield was 1.7% (low versus before the great financial crisis). It's now 2.4%, which is actually close to normal (a 2+% handle would be normal). That, in fact, is the biggest explanatory piece.

We've long argued that 4.5% is 'normal' for the US 10yr yield. And for the eurozone, that translates to 3% for the 10yr. We're now running at some 20bp above these normal valuations. That 20bp can be explained by issuance pressure (bad) / productivity expectations (good). The latter refers to the AI productivity revolution, which has a direct theoretical link to the real yield – another important piece.

And what about the Iran war effect? Simple optics suggest the 10yr yield rose as the Iran war kicked off, the oil price spiked and inflation rose. However, despite this, inflation expectations (break-even inflation) are contained (10yr inflation break-even at 2.25% in the US and the eurozone is absolutely fine if a moderate inflation risk premium of 25bp is included i.e. implies inflation of around 2%). So, interestingly, the rise in long yields is actually not down to higher inflation expectations, as they remain contained. Quite the juxtaposition.

That aforementioned 20bp extension above normal can extend towards 50bp (US 10yr @ 5% and Eurozone 10yr @ 3.5%). But only at the extreme, and likely only temporarily. Sustained breaks above that would risk some crisis thinking, which would ultimately prove self-correcting. In fact, averaging in the region of here is very probably a decent medium-term strategy once we get past the negative market-to-market risk on longs still probable over the immediate few months.

And for the eurozone – a lot of near-term negatives

The German 10y yield climbed above 3.25% on Tuesday, thus clearly breaking above the peak levels over this crisis thus far. It is hard to pin down one particular driver. Rather, we are dealing with a confluence of factors that has led to the latest elevation in rates.

In the eurozone, the backdrop is the European Central Bank, which looks set to hike rates again in September. In addition, there are dwindling prospects of finding a solution to the conflict in the Middle East. But more specifically in Europe, perhaps, it is that markets have been somewhat more sensitive to the concurrent elevation in gas prices, given also the lagging efforts to replenish storage into the upcoming heating season. Add to that the drought-related supply chain issues, but also ECB Chief Economist Lane is already pointing out climate-related food inflation over *next* summer. Relative to its US peers, EUR rates are facing more pressures in terms of inflation risk premia and expectations, and this has now put more upward pressure on the front end out to the belly. But also the long end is not spared. Keep in mind that the EUR issuance is also seeing a comeback following the summer break. That included an early syndicated 30y Bund tap.

The list of near-term positives for rates? Other than high absolute yield levels now, they are hard to make. But the higher rates are feeding back into some equity softness, which might take some steam out of the upside dynamic. But looking at the overall tally for EUR rates, it might explain why e.g. 10y Bund yields failed to follow 10y US Treasury yields lower when they found relief after coming close to the 4.75% mark.

Wednesday’s events and market view

Following the UK’s CPI data, the only notable events over the course of the European session are ECB President Lagarde’s appearances at the IBC meeting, including a panel session on the 'global economic outlook'. The eurozone will also release final inflation data for July.

Only later will we also get the July FOMC minutes, likely to be closely followed given the muddled messaging from new Fed Chair Kevin Warsh at the last press conference.

In the primary market, Finland has mandated banks for a new 7y benchmark. Germany will auction €6bn in 10y Bunds and the US Treasury will later auction a new 20y bond for US$16bn.

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