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Rates Spark: So how bad could this whole thing get?

We took a bit of a breather on bond markets through Wednesday. But here s a question – how bad could things get for the back end? We map out some causes and effects, and draw some historical parallels. We don t call for it, but the height of the dot.com boom saw the US 10yr real yield hit 4%. And the 10yr nominal yield? 6%

We see the US 10yr yield approaching 5%

The drivers of higher long tenor yields

There are two key drivers of long-dated bond yields – inflation and the fiscal deficit. The former impacts the real return attainable from bonds, while the latter helps determine the supply of bonds. Arguably, nothing else should matter, and if they do, it's only to the extent that they ultimately impact inflation and the supply of bonds. Fundamentally, the recent rise in long bond yields relates back to these.

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 30bp above these normal valuations. That 30bp can in part be explained by the aforementioned factors.

At the same time, the dominance of higher real yields as the driver of nominal yields in the past six months suggests that the pressure being felt in long rates is not necessarily inflation dominated. Higher real yields reflect issuance pressure (current and anticipated). But it also likely incorporates a positive productivity growth slant coming from the AI revolution. Fed Chair Warsh specifically referenced a positive secular growth dynamic up for discussion at the opening of the G20 summit in North Carolina. That gels with higher real rates, and fits with the upward pressure being seen on long-end yields.

A notable story too is the Japanese 30yr yield, which has touched 4.2%. That's four times the policy rate (currently 1%). There is clearly a tension between these two. The genesis of that is the evolution of a normalised inflation dynamic. The Bank of Japan (BoJ) has undershot versus this, so the long end has had to overreact. But the root cause here is a slow BoJ.

US fiscal pressure, together with a changing (US) political dynamic, has injected an increased defence need for European governments, in turn adding to fiscal spending requirements in the future. And various energy shocks have added to European inflation pressure. That, together with a far more troubling contemporaneous inflation dynamic, is forcing eurozone yields to the upside.

On the back end, there is also a relative value re-pricing required so that eurozone long-end rates sit appropriately versus alternatives. For example, in March this year, the 30yr Japanese yield moved above the 30yr German yield, and that spread has since widened to the 40bp area. That's a simultaneous relative value pressure.

Our base case, and painting some extremes

A key area to watch is 5% on the US 10yr yield. Breaks above that would likely be resisted by the US Treasury. If the 10yr yield does break above, note that 5% is not particularly high, and we already hit that level back in 2023. At '5%', we're 50bp above neutrality. But we arguably should be there, given where inflation (3+%) and the fiscal deficit (6+% of GDP) are printing.

We will in all probability test 5% for the US 10yr (now 4.8%). That equates to just under 3.5% for 10yr Euribor (now 3.3%). The US 30yr would be slippier than the US 10yr, likely approaching 5.5% (now 5.25%). That’s well above the 2023 high at 5.1%. Getting to 5.5% pulls the Euribor 30yr to an extremity of 3.6% (now 3.4%). The base case view is that we climb back down from there.

The risk case is we may have to endure an overshoot before things structurally calm, as the current upside pressure on real rates remains intense. And, the fiscal picture is particularly worrying. Note that in 2000, the 10yr real yield hit 4% (now 2.5%). That was at the peak of the dot.com boom. The 10yr Treasury yield hit 6%. The 10yr German yield was at 5%, but was at the tail end of a decade post reunification.

For an extreme ahead? We don't call for it, but 6% is not an implausible absolute extreme for the US 30yr. For the eurozone back end, the big figure 4% would mark an equivalent extreme. Hard to see moves above these levels. Sustained breaks above that would risk crisis reactions, which would ultimately prove self-correcting.

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