Rates Spark: An uneasy calm

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US Treasury long-end buyback talk continues to reverberate, but will slowly morph toward a front-end focus as we wind up towards Jackson Hole on Friday. Meanwhile, geopolitical headlines suggest more economic uncertainty ahead, while market-implied volatility measures see no concern, which is a concern

US back end behaves itself as focus slowly switches to the front end

The US 30yr swap spread continued to edge lower through Tuesday. Not by much, by a basis point, but is, in cumulative terms, tighter by some 6bp since last week's "at least doubling of buybacks" announcement. That, no doubt, is pleasing for Treasury Secretary Bessent, as it identifies a material richening of long-end Treasury yields relative to long-end SOFR (aka "risk-free") rates. In addition, the absolute 30yr yield is back down to the lows that it saw on the day of the announcement. Similar for the 10yr yield. The absolute level of long-end yields is the focus of the buyback strategy, but the swap spread is the better measure of the distilled effect of the policy, on a theory that an absolute richening versus the risk-free rate identifies pure impact.

The carry spread (fed funds rate to the 2yr yield) has also calmed back below 60bp, and so, still playing with the notion of a 25bp hike at some point. But it's not that convincing. Traditionally, the carry spread is in the 75bp to 100bp range ahead of a rate cycle. Neutrality would be in the area of 30bp (where funds rate stability is anticipated). So, it's closer to discounting a hike than not, but without conviction. In the meantime, the ongoing richness attached to the 5yr part of the curve tells us one of two things. Either, 1. The Fed does not hike. Or, 2. If they do hike, they will subsequently cut by more than they hike, and those cuts come within the coming 18 months.

While Treasury Secretary Bessent continues to boss the back end, or intends to. Chair Warsh would probably like to do the same on the front end, but has chosen to lie low for now. He'll have a chance to opine some more on Friday at the Jackson Hole Symposium. We don't expect a whole lot though, apart from his commitment to achieving price stability. There'll be all kinds of expectation for him to opine on the elevated deficit and the increased long-end buybacks. But don't expect much. Far more likely that he'll be balanced and non-committal; at least until we get to the point where he can convincingly voice a rate cut preference (not this Friday though).

Market-implied volatility measures do not reflect intensification of geopolitical risks

While headlines suggest a further intensification of geopolitical risks, volatility measures don’t seem to reflect such concerns. Equity measures such as the VIX are pointing at a very benign risk environment, being close to this year’s lowest levels. Also, the implied rate volatility is very well-behaved. The volatility of the short end of euro rates has clearly drifted lower over the past month.

One could argue that the tail risks of a full escalation in the Middle East have eased again. Signals that the US is actively seeking to open the Strait of Hormuz reduce the probability of oil surging well past $100/bbl again. But until we see concrete steps towards a reopening, the path of least resistance remains for a drift up from current prices. Also, watch European gas prices as these continue to trade at this year’s high. As we approach winter, the rebuilding of gas reserves can trigger more volatility.

In addition, we also have the uncertainty around second-round inflation risks, which could challenge current central bank pricing. Overall, we think the second-round effects should be limited because wage pressures remain subdued. In our baseline, we therefore only see the European Central Bank hike rates once more, but higher oil prices for longer could easily trigger a hiking path towards 2.75%. Meanwhile, markets have turned more dovish for the Fed, but data like Wednesday’s PCE deflator continue to pose uncertainty.

Wednesday’s events and market views

Besides geopolitical headlines, the US PCE data should draw markets' attention. Consensus expects a 0.2% month-on-month for the core reading and just 0.1% MoM for the headline. Such numbers would help the Fed hold rates stable during September's meeting. Other data includes US personal income and spending numbers from July and also durable goods orders.

Italy will auction €2.5-3.0bn of a new 2y BTP. Germany will auction a 15y Bund and a 22y Bund for a total of €2bn. The US will auction $28bn of 2y FRNs and a new $70bn 5y Note.

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