Rates Spark: Curve influencers

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Warsh and Bessent – the bond influencers. But bigger market pressures should dominate. Tactically, the oil price drives much of the short-term moves in rates. Structurally, it's the global rise in real rates – that is the real influencer

Here's why Kevin Warsh and Scott Bessent can both see silver linings from latest developments

Key moves are being seen on both ends of the curve through Monday, as the market continued to digest Chair Warsh's words from Friday. On the front end, the probability of a 25bp hike from the September FOMC meeting has flipped from 50:50 to 3:1 in favour. That's meaningful. Not quite fully discounted. But absolutely heading in that direction. On the back end, the 10yr break-even inflation rate continued to ease lower. Only by a few basis points. But it's the kind of move that should please Chair Warsh, as it suggests that his hawkish words have acted to contain inflation expectations, even if they weren't high to begin with (still in the 2.3% area).

However, the 10yr yield continued to edge higher, just as it did on Friday afternoon. The culprit is ongoing upward pressure on real yields, a theme we've opined on now for many months. Higher real yields suggest that the pressure being felt in long rates is not from inflation. It's from a combination of issuance pressure (current and anticipated), and it likely incorporates a positive productivity growth slant coming from the AI revolution. Chair Warsh specifically referenced a positive secular growth dynamic up for discussion at the opening of the G20 summit in South Carolina. That gels with higher real rates.

The optics of seeing Treasury Secretary Bessent deplaneing with Fed Chair Warsh from Air Force Two were interesting. Not indicative of anything specific, apart from a reminder that both of these men have their attention squarely on the front end and back end of the yield curve. Chair Warsh effectively warned us on Friday that front-end rates may need to be adjusted higher. A week or so earlier, Treasury Secretary Bessent moved to contain long-end yields through an intention to more than double the volume of long-end buybacks. He went on to assert on Monday that he was not targeting any particular level; rather, he was just prodding the market towards a fairer valuation, from his perspective.

Ahead, the front end is liable to remain sticky now at elevated yields unless negated by a weak payrolls report on Friday. But back-end yields remain under rising pressure. We continue to anticipate a move in the 10yr yield into the 4.75% to 5% area as the real-rate elevation pressure remains. Note that Treasury Secretary Bessent can still claim a victory lap, given the tightening seen in long-tenor swap spreads, vis a vis relative richening in long-end Treasuries. As a percent of total spreads, these are in some 10% since the buyback announcement, and looking reasonably resilient to the downside. Overall, the curve should steepen from the back end.

Printed Eurozone inflation is too high, but inflation expectations are still well-contained

Consensus sees August’s eurozone headline CPI number tick up to 3.3%, but inflation should not be the main concern for euro rates. On a daily basis, oil is the key driver of rates, but overall the pricing of inflation risks remains very well-behaved. The 2Y inflation swap stands at 2.5%, which is above target but far from alarming. Meanwhile, the 5Y5Y forward inflation swap is just 2.15%, reflecting a high degree of confidence in the ECB’s monetary policy.

The bigger source of uncertainty can be found in real rates, which have been drifting higher over the past years, especially in the US. Even though Fed Chair Warsh raises the risk of a perceived policy error, long-term market measures in the US still point to a benign inflation outlook. The 10Y inflation swap at 2.5% is actually at the lower end of the trading range from the past years. But with the 10Y UST at 4.75%, implied real rates are the ones testing new highs.

That doesn’t mean inflation risks can be safely ignored either. If we do get upside inflation surprises from the eurozone, euro rates can easily push higher still, especially at the short end of the curve. Second-round inflation risks remain a material risk and the ECB has shown a willingness to hike if necessary. And with growth numbers still showing a robust economic outlook, we would see little pushback against another more hawkish turn.

Tuesday's events and market view

Out of the eurozone we will get preliminary inflation data for August, with consensus eyeing a rise to 3.3% for headline inflation and the core rate staying at 2.5%. Releases so far are pointing in the direction of the consensus, but that still means inflation is currently running well above the ECB’s target with little relief from the direction of geopolitics. Other releases to watch out of the bloc are the final PMIs, which also provide the first individual August readings for Italy and Spain. From the ECB, Nagel and Vujcic will be speaking.

The US publishes the manufacturing ISM with consensus eyeing only a marginal softening to a still solid 55.3. Jobs-related data will be the main focus though, with the release of the JOLTs jobs openings data for July. The only scheduled Fed speaker for the day is Barr.

In government bond primary markets, Germany will auction €5.5bn in 5y bonds.

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